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INTERNATIONAL COMPETITIVENESS

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

NOVEMBER 16, 1987

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
87-027 WASHINGTON : 1988

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

5361-50

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INTERNATIONAL COMPETITIVENESS

MONDAY, NOVEMBER 16, 1987

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:32 a.m. in Room SD-215, Dirksen Senate Office Building, the Honorable Max Baucus (chairman of the subcommittee) presiding.

Present: Senator Baucus.

[The press release announcing the hearing follows:]

COMMITTEE ON FINANCE
United States Senate
205 Dirksen Building
Washington, D.C. 20510

PRESS RELEASE #H-72

FOR IMMEDIATE RELEASE
November 10, 1987

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT TO HOLD THIRD IN SERIES OF HEARINGS ON THE EFFECT OF TAX LAWS ON AMERICAN COMPETITIVENESS

Washington, D.C. -- Senator Max Baucus (D., Montana), Chairman of the Senate Finance Subcommittee on Taxation and Debt Management, announced Tuesday that the Subcommittee will hold the third in a series of hearings on the impact of the U.S. tax code on America's international competitiveness.

The third hearing is scheduled for Monday, November 16, 1987 at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

The first two hearings provided a broad overview of the relationship between tax policy and international competitiveness, as well as a comparison of the U.S. tax system with those of our major economic competitors. The third hearing will focus on testimony from representatives of various associations whose membership is directly affected by the problems of our declining competitiveness.

"There is growing concern about this country's declining international competitiveness," Baucus said. "Increasing our basic economic productivity is crucial to America's competitiveness, and that is where the tax code comes in."

"Our tax system affects virtually every aspect of our economy. But we have very little understanding about how our tax system affects competitiveness. These hearings are designed to begin to develop this understanding," said Baucus.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM THE STATE OF MONTANA, CHAIRMAN OF THE SUBCOMMITTEE

Senator BAUCUS. The hearing will come to order.

This is the third in a series of hearings this subcommittee is holding on U.S. competitiveness. Ironically, our last hearing was October 19, and it was during that hearing on a hourly basis that we learned the Dow Jones was tumbling—first 100, then 150; and we ended up with a fall, in the Dow Jones of at least 500 points.

I think we all knew during that hearing that the free fall of the market was symbolic of deeper problems facing our economy.

We knew that the problems revolved around the Federal budget deficit; they also revolved around what economists like to call microeconomic factors, namely the success or lack of success of individual firms. It is a very complex problem, and like a lot of problems, there are probably no easy solutions.

I am reminded of journalist H.L. Menkin who said that, for every difficult problem, there is a simple solution, and it is usually wrong. I think this problem requires a series of many individual steps which, on a cumulative basis, will help make America more competitive; and I think they revolve both around the macroeconomic problems facing our country as well as the microeconomic problems facing individual firms.

We are very honored to have as our first witness today Dr. Thomas J. Peters; and I might add that this is the third of three general hearings on competitiveness. We will hold subsequent hearings addressing individual components of competitiveness; labor/management relations would be one. Tax policy, particularly looking at consumption taxes, would be a second. And then, we will schedule other hearings as the needs seems to be most appropriate.

When we scheduled our first hearing, our first witness was scheduled to arrive. He got up early in the morning and tried to make it here; but unfortunately, there was a big snowstorm in Vermont, so he was unable to be here. We are very honored, Dr. Peters, that you are here today, and very much look forward to hearing what you have to say.

STATEMENT OF DR. THOMAS J. PETERS, FOUNDER, THE TOM PETERS GROUP, PALO ALTO, CA

Dr. PETERS. Thank you, Mr. Chairman. I am delighted to have made it this time, too. I came two days early to ensure it, and I nearly got caught in the Boston snowstorm this weekend. [Laughter]

So, it is a pleasure to be here. I was particularly intrigued to hear in your opening comments the comment about the issues being macroeconomic and microeconomic because, in fact, I suspect that I will be different from some witnesses today in that, although there is a series of policy issues that I want to briefly outline, my principal concern is with the microeconomic component, which I happen to think is a very substantial part of the problem. I guess my greatest concern, though, in a way is the issue of whether or not we will take advantage of the crash of October 19 because, by some irony, there is a *Business Week* and *Forbes* Magazine—both of which are on the newsstands today, both with November 16 dates.

The *Business Week* starts, and this is all on the cover. It says: "Wake up, America! The stock market may recover somewhat, but the message underlying the crash remains largely unheeded. The bill is coming due. America's standard of living seems bound to suffer."

Now, the November 16 *Forbes* Magazine, same time, same date, has Malcolm S. Forbes, Jr. is commentary; and that begins: A merchandise trade deficit is simply a number. The national debt is proportionately no larger today than it was 25 years ago . . . The economy . . . is healthy". Are we going to take this seriously or are we not? That is my concern.

Let me start, however, in a somewhat different fashion. The most exciting day that I have had in calendar year 1987 was spent about three or four months ago when I visited the tiny town of Van Buren, Indiana. What is exciting to me about Van Buren, Indiana is the good citizens there seem to have done what we were not able to do in Silicon Valley, Pittsburgh, or Detroit. In Van Buren is a company called Weaver Popcorn, which happens to be the biggest popcorn company in the world with about a 20 percent share of the U.S. market; but of much more interest to me, Weaver Popcorn has a 60 percent share of the Japanese market.

The reason it has that 60 percent share is that it has done everything that major corporations, by and large, have not done. Though it is a tiny firm without deep pockets, senior management spent years in Japan building relationships with a distributor. Weaver Popcorn obtained its preeminence in the United States through a 60-year reputation of superlative quality. Nonetheless, when Weaver shipped its first order to Japan, the order was immediately rejected by the Japanese as having lousy quality. The good news for Weaver is that, as only a $30-million firm, they were therefore not able to come to Washington and beg for relief; they were too small. So, they had to fix the problem.

Without knowing the potential of the market in Japan, they went ahead—a small company—and invested over half a million in an advanced optical scanning system that allowed them to beat the best of the Japanese quality standards. The Japanese said they liked their popcorn orange, even though it doesn't affect the quality of the popcorn; and so, Weaver said: Fine, if you want it orange, you can have it orange.

The net result of it is that two and a half years later they have a 60 percent share of the market.

And another sort of good news story is indeed one that is only 30 miles from my hometown in Silicon Valley. It is not a Silicon Valley success story, though; it is an automobile industry success story, and that is the General Motors/Toyota joint venture called New United Motor Manufacturing, Inc.

General Motors shut its Fremont plant down about five years ago for the best of reasons: the quality stunk; the productivity stunk; absenteeism was running about 20 percent on Fridays; the union regularly called wildcat strikes. It was a miserable situation; and so, 5,000 jobs bit the dust.

Today, that plant is up and running, and it is a lot more than up and running. It makes the highest quality cars, according to some surveys, in the North American continent. It has productivity that is 50 percent above the General Motors average. Absenteeism is running just a couple of percent instead of 20 percent; and instead of several thousand grievances a year, they are down to about ten a month.

The answer was not to throw the union out. The answer is not robotics. In fact, many of the same human beings were hired back. The same nasty, tough UAW leader came back as president of the local organization. And the issue, the story, the answer in this case is called people: team organization, training people in multiple jobs, asking people to participate.

It is a people story, not a robotics story, across the board. That is the good news.

The bad news, as far as I am concerned, is the overwhelming story; and I am not going to bore you or waste your time with the little card that I carry around that, when people say to me: "Gee, isn't it true that we have created a whole bunch of jobs" and so on? And so, I got out my little card, which says: Deficit debt, savings, speculation, productivity, income deterioration, civilian R&D, expectations about the future generation, trade, and so on and so on and so on. I see no good news frankly.

To be honest with you the one that I think bothers me the most is: A week ago yesterday, Senator, I became 45-years-old, and when you hit the age of 45, you can't delude yourself any more; you are of the leadership generation, like it or not. We are, if I understand the polls—you and I and others of our generation—the first generation since the Pilgrims to be predicting that our children will be less well off than we are. And that is not the legacy that I choose to leave behind; and I think the basic reason here is the rot throughout the economy.

The numbers, you are more familiar with than I; and I am not going to talk about debt and deficit. I am not even going to talk about the trade issue as much as I would like to.

What I want to talk about is, in fact, the microeconomic issue because, to me—and this is the way I reason—the debt and the deficit numbers are awesomely important; but the real deal is that you can't go more than two days reading *The Wall Street Journal* and not see on the front page: Procter & Gamble writes off $.5 billion; Monsanto writes off $.5 billion; DuPont, Dow, General Motors, Chrysler, Ford; IBM is even having trouble; CitiCorp wrote off $4 billion; Kodak.

I am not suggesting these firms are about to go into Chapter 11, but there is simply not a single major bellwether American corporation that is not going through traumatic change at this stage of the game. The microeconomic performance stinks. There is no better example of that than, in fact, the General Motors Corporation. We are all Detroiters at heart, including we people of Silicon Valley. Detroit buys more of our semiconductors than anybody but the Department of Defense; and yet, in fact, the General Motors story is a pathetic one on the competitiveness scene.

The mid-May numbers and things are slightly better today. They show that General Motors had lost fully one-fifth of its market share in just one calendar year, and that was without any major labor dispute, with the continued declining dollar vis-a-vis major competitors and with incentive give-away programs that were aimed at saying: "Will you take these things for free?"

With all of that, the most powerful, dominant private-sector company on the planet lost 20 percent of its market share. And I believe that it is due to lousy productivity which was brought about by inept management; it's the perils of too much bureaucracy coming home to roost.

And it is really to that issue that I want to briefly turn right now. I think in some respects we are seeing excessive bureaucracy coming home to roost everywhere. The symbol for me was not a private sector one but a public sector one, and that is it basically turned my stomach to realize that, after six years of quarter trillion per year spending on the defense budget, the world's most high technology Navy is tied up in the Persian Gulf by a bunch of commercial Iranian speedboats with commercial machine guns sitting on their bows. Of course, as somebody said to me in a seminar the other day: "For God's sake, Tom, don't go to Washington and recommend that the Navy build that kind of speedboat because you know what it will be—a ten-year program, $25 billion, and each one of them will end up 150-feet long, three tons, way overweight, with enough electronics on them that they could be smelled from two continents away; but not to worry, because it won't work under fire, anyway."

And that is obviously not very funny, to put it mildly, but that bothers me. The new language we are seeing in fact, in the crash of October 19, was indicative of this. It is a whole new set of language: break-up value, disintegration, demerger. The newspaper headlines focus on the mergers; the real world, however, is in some respects just the opposite of that.

The most compelling theory of the excessive ranges reached in the stock market suggests that would-be corporate raiders and securities analysts were essentially valuing most of the Fortune 500 based on their value if you broke them into pieces. We have simply started to get—I started to say "muscle-bound"—really "flab-bound" by orders of magnitude in our most huge companies.

The merger situation—and I am not here in any way, shape, or form to suggest that we restrict mergers or restrict antitrust—I don't happen to believe in that; but in fact, all of the studies suggest that the mergers do not work.

If there is, in fact, a vital part of our economy, it is the so-called mid-size company. The mid-size company which is succeeding so well, for example, in steel where, despite the devastation of Bethlehem, U.S. Steel, et al., the minimill/micromill sector represented by such companies as Chaparral of Midlothian, Texas and Nucor of Charlotte, North Carolina, are just really moving along on a fast course.

Every market we see is disintegrating into ever-tinier pieces. This may be the era of the moderate-size company; but before talking about that, let's just take one small detour and talk about the root causes.

I believe that fundamentally there are three basic things that have led to America's previously great microeconomic performance; but now they are all coming home to roost as negatives vis-a-vis our biggest competitors, our best competitors. Americans believe first of all that big is good, bigger is better, and biggest is best. We love it if it is huge, no matter how lousy it is basically. Secondly, Americans from the days of the Pilgrims have always honored volume over quality.

We do not in this country have a quality tradition to fall back on, sad to say. As the great quality expert, W. Edwards Deming, said recently, Henry Ford deserves a tall statue for changing the world; but the other side of the coin is, said Dr. Deming, the Model T, as great as it was, was not a high-quality vehicle. The American strategy, starting with the Pilgrims and peaking in World War II, was the Pilgrim theory: plant corn, abuse the land, and move five miles to the West; and we are now out of West in this country and being competed with by people with a different strategy.

The third of our major philosophies has been the labor philosophy, and the American labor philosophy has been clear; and that is to specialize labor ever more narrowly until such time as you can find a way to eliminate it entirely.

My belief is that we can, in fact, portray the effective competitor, whether it is Federal Express, The Limited stores, whether it is an independent division at a Hewlett-Packard or a Du Pont, or whether it is one of these minimill steel companies or what have you. The forces of generic economic uncertainty, the technology revolution, new competitors from everywhere are leading to total turbulence in the market, a series of outcomes that mean unparalleled uncertainty, the total demise of mass markets as we have known them—even in automobiles and steel—more consumer choices; market fragmentation, the demand for quality, more small and mid-size firms emerging.

The new winner—the new American winner—will be a niche-oriented market creator; flatter with much less organization structure; faster; more quality conscious; internationalist—whether you are a $5-million service firm or a $5-billion manufacturer—smaller, either as stand-alone units or smaller units within big firms; and above all following the strategy of value added through people.

Unfortunately, that brief list of seven factors happens to be precisely the antithesis of everything that we have believed from a managerial or microeconomic standpoint through the course of the last 100 to 150 years.

Of all of those factors, there are two that I want to dwell on for just a moment; and then I will get into, finally, my policy suggestions.

The first one, which I feel emotionally about, as well as analytically about, is the issue of product quality.

Americans don't make good stuff, says the rest of the world. We do not have a quality problem in the United States; we have a bloody quality disaster. Our third biggest trading partner is West Germany, right behind Canada and Japan. A recent Roper survey asked West Germans: Do you consider "Made in America" a mark of quality? Six percent of Germans said "Made in America" was a mark of quality; 94 percent said, in effect, Americans make junk.

I don't like picking on the automobile industry any more than anybody else, but nonetheless I think we ought to face the facts with the figures. I watched a business-news show yesterday where the president of General Motors, for the 18,311th time, attempted to explain away the General Motors quality problem by saying that people have great expectations about GM cars. That is nonsense, at least in the State of California where I live; people have no expectations, sad to say, of American cars any more. GM's market share remains 40 percent in the United States; it is 25 percent in the little, tiny 28-million person State of California.

I am not going to go through polls and numbers, with the exception of one. On that weekend in Vermont that we were talking about, when I arrived on my farm, my neighbor was, in fact, in the process of buying a used car; and lying on the table in my living room was the 1987 *Consumer Reports* issue which recommended used cars.

Now, I only bring this up for the following reason. One of the rejoinders I hear occasionally is, "Well, the Japanese cars may have good door-closing sounds; but five years later, they all fall apart." The answer is: Guess again. *Consumer Reports* recommended over 100 cars that would be the best used car buys; this is 1981 to 1985 models. Put this in the context of two-thirds of the cars sold during that period, over two-thirds remained American. Recommendations: 19 U.S. cars recommended, 23 European, 70 Japanese.

Now, the next page went on to recommend cars not to buy: 14 Japanese models, 13 European models, and 237 American models. That is not called "taking your eye off the quality ball;" it is called getting killed.

And isn't it interesting that, surprising to many people—it certainly shocked me when I first came across it—that perhaps the most profitable Fortune 500 company, and maybe the pharmaceuticals are a little more profitable, makes the most boring product in the Fortune 500. It is Deluxe Check of Minneapolis, Minnesota; they make, as their name suggests, the super paper bank checks.

Deluxe Check, 51 years ago, developed a policy which said: Every order, no matter how complex, will be shipped the next day. In other words, superior quality. They print their quality statistics in their annual report. Last year, the company had $867 million in sales, $121 million in after-tax profits, which is an awesome number. This year, it will be $940 million in sales and $150 million in after-tax profits. Pure, garden-variety, vanilla quality does count.

I want to then talk about one final issue, and that is the people issue. Robert Reich's marvelous book, *Tales of a New America,* said that the United States has two choices. We can follow a policy in which we attempt to match the Indonesians on wages, or we can follow a policy of adding value through people. It is the latter policy that makes sense. Let us not kid ourselves; the United States is not pricing itself out of the market on the price of labor.

In the little town of Bayport, Minnesota in the far, far north of the land is the $790 million Andersen Corporation, making another mundane product, namely storm doors, windows patio doors, and so on—more of them than anybody else in the world. In the middle of May last year, 3,500 hourly workers at Andersen Corporation divided up $72 million in one single profit-sharing check; that is over $20,000 a person. It was an eight and three-quarter a month profit dividend.

How can you do that? How can you pay people that much money in the patio door business? Simple. Their productivity is 200 percent above the industry average.

There is a third topic, and I see it in my notes here; and I can't help but digress into it. I went to a lovely little dinner Saturday a week ago, and I think it spoke to most of our problems in international markets. At that dinner, my wife attended and she had just come back from a three-week visit to China. And another fellow, who had visited China for three weeks at exactly the same time, was there, too. My wife had an absolutely magnificent time. She met numerous people; she went to all sorts of off-the-beaten-track places. She thinks China is just a very, very exciting, albeit very radically different, country; and the other guy just hated the Chinese. He said they are a bunch of obfuscating bureaucrats. They put up all sorts of barriers in the way of doing anything, starting with going to the bathroom. Now, what do you suppose the difference was between my wife and that fellow? Very simple. My wife spent the last two years studying Chinese and is fluent in Mandarin; and that fellow was like most Americans, whether trading in Japan or China or a tourist, and couldn't even say hello, goodbye, or how much does a taxicab cost in the native language.

Yes, playing fields are unlevel; but in fact, if one would do such "trivial" attributes as learning the other person's language, we would find that a lot of that mismatched leveling would go away.

My own policy recommendations, and certainly relative to the subcommittee—and I am no tax expert at all, so I want to speak in generalities. Number one, my suggestion is: Do not slow down competition. I am not, I will have to acknowledge, one of the world's great fans of the Omnibus Protection Act, or Trade Act, as it is called.

But I do acknowledge that, in fact, playing fields are not level. I am not a dewy-eyed fair trader, but my question is this: Can we legislate against the 240 days a year the Japanese spend on average in the classroom, compared to our 180? Can we legislate against the Japanese national obsession with child-rearing and education? Can we legislate against the Japanese penchant for product quality? Can we legislate against Japan's shortage of natural resources, which has always led them to focus on people as their number one resource? Can we legislate against the arcane, multilevel Japanese retail distribution system?

Can we legislate against Japan's attraction to foreign languages and our aversion to them? Can we legislate against Japan's love of the miniature, as opposed to our love of the large? They think Sony Walkmans are beautiful; we think Plymouth tailfins are. Can we legislate against Japan's penchant for continuous learning on the job and continuous improvement, versus our so frequently futile search for the big breakthrough? Can we legislate against the willingness of the Japanese as an underdog to take on long grueling overseas assignments?

Can we legislate against Japan's penchant for partnership and aversion to lawyers and written agreements, versus our penchant for adversarial dealings and love of lawyers and contracts? Can we legislate against their conservative coalition, which makes them half a democracy, compared to our pluralistic faction-ridden approach to everything?

Can we legislate against Japan's Sogo Shosha, their big trading companies to which they take to as instinctively as we don't?

Those are the things, in my opinion, which drive most of our problems with our second biggest trading partner; they cannot be cured by legislation. My major enmity toward any protectionist legislation has nothing to do with theory and frankly nothing to do with unfairness.

The problem is that protectionism doesn't work. If somebody, in fact, gives a youngster an extra day home after he faked an elevated temperature to study for a test, he doesn't study for the test. He watches game shows on TV.

And our experience in the United States and around the world for several hundred years is exactly the same relative to protectionism. I don't like it because it stinks, because it doesn't work.

Number two: Let the raiders alone. I do not believe the corporate raiders are altruists. I have no desire to have any particular one of them home to dinner, to be very honest with you. Nonetheless, I think that America's approach to competitiveness will be radically different from Japan's, and I think that the number one arrow in our quiver is the vitality of our capital markets, which in part has brought about the small business, mid-size business explosion.

Moreover, sad to say, the raiders—even more than the Japanese—seem to be the only force powerful enough to truly terrorize the often asleep-at-the-switch chieftains of the corporate 500. And anybody who will scare that group of 500 to death is my friend, no matter how unsavory they are on some dimensions.

Number two point: Train and retrain. Training, training, training. We need a GI Bill, whether it is Pat Choate's Individual Training Accounts or whatever it must be; America must learn through tax incentives, through such things as the ITA—we must learn—to put people at the top of the agenda. We don't. There is nothing in the Tax Code; there is nothing in our generic attitude; there is nothing anywhere which would find us putting people first. Remember NUMMI; the story is a people story, not a robotics story.

Furthermore, under this same issue, I am a strong supporter of worker incentives. I urge more support for the ESOPs, support to move us strongly toward higher shares of gain sharing, profit sharing, or profit and quality improvement-based compensation for workers.

Number three: Remove the capital gains tax. If there is a single thing that I find unattractive in the Tax Act of 1986, it is in fact the removal of the capital gains tax relative incentive. I think what I call the small and mid-size business sector—and if I can digress for half a second, one of our problems as we look at this new world is language. We have two words in America: big business and small business.

Big business is Exxon; small business is a mom-and-pop grocery. The effective competitive unit may well be the couple hundred million dollar firm—stand-alone or as a part of a bigger company. I suggest that we need substantial legislation and incentives over the long haul that acknowledge this vital part of the economy, not just the SBA part of it, but this part that is sitting in the middle—the American Business Conference sorts of companies, whether they are Weaver Popcorns or Chaparral Steels.

Promote internationalism is the next point, in any way that we possibly can. Above all, incentives for Americans to be sent overseas, somehow coming to grips with the issue of foreign language trading. I would support paying for some of these programs I am talking about, such as the awesome increases in training and tax incentives to spur worker bonus compensation, some form of a general consumption tax that would not be applied to exports.

The next point I feel helpless about. In my words that I have written for you in my testimony, in fact, say: Do "something" about the quality issue: Jawboning as individual members of Congress; jawboning using the White House; jawboning somewhere, somehow. The only half facetious comment that I made last year at the White House Small Business Conference was: Let's knock off quarterly profit and loss reporting to the SEC, and instead institute quarterly quality reporting.

I don't mean it; it is unworkable; but I don't know how we get there from here.

Strong support for civilian research and development, with a particular bias toward university/industry cooperation. And I stress the words university/industry cooperation because I am no fan of such industry collusion tactics as MCC, Sematech, and other activities which I believe to be fundamentally anticompetitive. I am a radical supporter of R&D, but not when it means big companies getting together.

Those are the major points that I would make. The *Fortune* magazine, which just came off the newsstand, had a big article on the Harvard Business School, and that got a lot of press attention; and so, it is probably all that people read. Buried on page 88 of that issue was a little interview with the President of Honda Motor Company. Honda already develops cars twice as fast as we do, and its productivity is probably 50 percent again as high as ours.

The President of Honda Motors said it was his objective with all of the tools already in place, to increase productivity at Honda by 300 percent—300 percent—in the course of the next couple of years. That is an awesome number.

As we look at tax incentives before your subcommittee, as we look at microeconomic policies, we have got to own up to the fact that American business is in desperately serious trouble. It is in trouble largely because of our own, i.e., managerial, making. I believe there are some policy things that you can do to help. The other side of the coin is that I stand in fact with the great quality gurus—Phil Crosby, W. Edwards Deming, and Joseph Juran who, when asked management's responsibility for quality and productivity, say 90 to 100 percent. That is where I would stand, with a little bit of bias close to the 100 percent side.

Thank you very much.

Senator BAUCUS. Thank you very much, Dr. Peters, for that inspirational statement. When people listen to you I think they agree with your diagnosis of what a lot of the problems are. They are very basic; they have to do with our American penchant for bigness and for volume over quality. I think that is very true.

I think also we agree that, even though America still is the most prosperous country in the world, generally we have some very deep underlying problems; and you went through the list. And you have also, I think, very well explained some of the ways in which we should move. A lot of this is a management problem, that management should pay more attention to labor. You also talked, again, about quality, and education, and R&D, and so forth.

The real question that comes to mind is: How do we get at this? How do we encourage American people to agree with some of the actions that have to be taken?

For example, here we are in the last three weeks trying to reduce the budget deficit. We all agree that the budget deficit has to be very significantly reduced; but to do so, that means cutting spending. It means some entitlement programs should be addressed. Defense spending is still too wasteful. Other spending programs just have to be cut.

In addition, part of the budget deficit reduction may include more revenue. People don't like paying additional taxes. So, as we address the Federal budget deficit and actions which in the short term hurt people, and then as we try to encourage management to address quality and to do all the things you are talking about, how do we get the American people behind us?

Dr. **Peters**. Right.

Senator **Baucus**. It comes down to a cultural and attitudinal question?

Dr. **Peters**. Yes, sir.

Senator **Baucus**. How do we begin to address this?

Dr. **Peters**. Obviously, that is the $64.00 question. I guess my own feeling is that, at the very top of that list, from the White House to these hearing rooms, is we have got to take the rose-colored glasses off. And in our language, as leaders in Congress and as leaders in the White House, we have got to start speaking something that approaches the truth. I am not sure, even to use your words that are a lot less optimistic than President Reagan's, that we are the most prosperous nation.

I don't think it helped in the State of the Union speech to say: How does America ensure its position as number one in the 21st century? I am not sure we are number one. President Carter gave the word "malaise" a bad name; and so, nobody can edge up to the truth without being accused of repeating the great malaise speech. I am terrified about that, to be honest with you, in the 1988 presidential campaign. Candidates are not "allowed" to say things are bad.

I thought the performance at the other end of this avenue after the October 19th crash was disgraceful. It is a once in a generation opportunity to bring people together around a serious problem. I don't think the performance up here has been anything to write home about, either.

I was doing an *Adam Smith's Money World* television program about six months ago, and one of the fellows who was on there with me was Doug Fraser, the former UAW president, of course. And I have incredible respect for what he has done throughout his career. But when we talked about the quality issue, though he said: "We took our eye off the ball a little bit." That is utter baloney. We didn't "take our eye off the ball;" we got killed, clobbered; wrong playing field; wrong size playing instruments. You know, we brought bats to a football game, if you will.

I think that the start of it is to at least thin the lenses, if not take off the rose-colored glasses. I mean, the analogy I like to draw is this: Arguably one of the most effective human social service agencies, if you will—private—is Alcoholics Anonymous. And the deal at Alcoholics Anonymous is that you stand up, for starters, in front of your peers and you say: I am a drunk. And after that, there is a 14-step deal, or something like that, toward recovery. I think as a nation we have got to say relative to excessive spending, from the Capitol Hill side to the world of excessive fat and flab in the private sector: I am a drunk, if you will, relative to our economic performance.

So, I think malaise is not the answer. It is not screams of despair followed by throwing up the hands. This subcommittee has an extraordinary number of ideas. The White House has an extraordinary number of ideas. We are not without ideas; and so, that is the second half of the message—do something.

I think extraordinary honesty about this issue is essential. One thing that is bothering me beyond belief right now is just letting the dollar drop through the floor. Now, I realize that the dollar was way overvalued in 1981, but the decline of the dollar is a straightforward decline in the standard of living, particularly in the State of California, where I live and there is, it seems at times, a 100 percent market share for Hondas—I mean, literally.

Why don't we talk about that? I have never seen it written anywhere. You know, National Quality Month was October. I said that to a reporter the other day who was interviewing me, and he said: "Where? Japan?" That is how effective a job we have done about publicizing our issues.

You see R.C. Stempel, the GM president, on the television yesterday saying something like: "What's with all these polls? I mean, people really expect a lot more from a Cadillac." That might be true relative to Cadillac's shabby performance in the polls, but that does not explain the problems with Chevrolets, Oldsmobiles, Pontiacs, Buicks, and the other five million cars, or whatever number it is that GM makes.

And I think we have just got to start with a real heavy dose of talking straight about these issues. And one other thing, which I thought a little bit about before I came down here, about whether I wanted to say it on the record; and I think I do, relative to revenue raising. And I speak not as a macroeconomist with a commentary on what the effect would be overall. But there is one group of people who could probably handle a little bit of additional taxation, and that is a group called the rich. You are looking at somebody who, unlike most of the people who have testified before your committee, does not belong to a corporation. I am an independent person. I am very lucky because I have done real well with my books, to put it mildly. I get paid an obscene amount of money, to be very honest with you, for the things that I do.

I am very pleased that the Congress of the United States and the President will be giving me a windfall of several hundred thousand dollars a year, if we go down to the 28 percent tax bracket; but I didn't need it. I don't need it. And it would actually be okay if you hit us a little bit harder. I think it is absurd, frankly, that that is not the case; and that is said not as a macroeconomist. I don't understand fund flows; I don't think any macroeconomists do either, but that is neither here nor there. That is a another issue.

Senator **Baucus**. In addition to explaining what some of the problems are, I think one way to get the confidence of the country is to show some successes. How do you get from A to B? People just don't like to hear bad news all the time.

Dr. **Peters**. That is right.

Senator **Baucus**. They want solutions. And you have begun to do that because you have talked about some success stories that show how some firms do well by attention to quality and so forth.

Dr. **Peters**. Right.

Senator **Baucus**. What ideas do you have as to how that can be expanded? Or to ask the same question a bit differently: Are there any legislation suggestions here to help encourage more firms to do the things that successful firms do?

Dr. **Peters**. Yes. Let me answer it in two ways. I think the biggest area of encouragement, in my opinion—and as you can tell from my remarks, I believe in as little regulation as is plausible—but there is a huge exception in my mind; and that is that everything you can do from a tax and programmatic standpoint to help right the balance between our overemphasis on hardware and our underemphasis on people. To me, if there is a single theme that goes from Hewlett-Packard to Weaver Popcorn to Chaparral Steel to Nucor Steel to the NUMMI plant in Fremont, it is an emphasis on people.

Now, my desire would obviously be that managers come to that belief on their own. They are not doing so. There is a pathetic story that I read recently in a young man's dissertation from the General Motors Institute about the over-1,000 General Motors managers who have visited NUMMI. They visit NUMMI; they see the success there. It doesn't have many robots compared to an average GM plant. And yet the only thing they remember when they are quizzed after a three-day visit is some little robotic deal that they saw. They don't see the people issue. Managers don't see it.

Senator **Baucus**. If that is the case, then should Congress do anything about that?

Dr. **Peters**. I think so. I mean, I love this idea of the people at Andersen coming home with a $20,000-plus check in mid-May. Let's work on the compensation systems and incentives that would encourage individual firms to give a larger share of their paycheck to the individuals for direct profit distribution plans. I think there is a lot that can be done there.

By the way, my ideas are not exactly the same as the much better known ones of the Harvard economist, Martin Weitzman. His emphasis is on tax incentives to employees, which I think probably is required to get union support. My suggestion also includes tax incentives for employers, not because they need it, but because if they are there, they will tend to take advantage of them.

And I think there is a need for very direct tax and programmatic incentives for training. We don't train people. Japan spends about three and a half times more per employee on training, after starting with a much better product, at least coming out at the high school level. We don't spend money on training. We ought to pervert the system in every way that we can. We have gone through years of perversion and support of hardware write-offs. Let's be a little bit positively perverse in terms of people-oriented write-offs.

Whether it is the ITA or whatever it is, but a very strong emphasis should be on the people stuff.

The other half of the issue is the jawboning half, and that is taking advantage somehow—calling attention to—the stories. Now, after the late Secretary of Commerce Baldrige, there is going to be starting—maybe next year—I guess a Baldrige prize for quality. I have zero hope for it. It is going to be, "Baldrige? Who was he? A Japanese economist?" In two years, that will be the story.

We aren't getting that message out about people who are improving things. The NUMMI story isn't being told outside of the San Jose Mercury News area, which is fine and dandy if you live in Santa Clara County, but doesn't help the rest of the world. I think it requires jawboning on the part of everyone, with one particular addition.

If we figure out how to do the jawboning, I hope that we will start emphasizing the Nucor Steels and the Weaver Popcorns as much as the improvements at the Xeroxes and Corning Glassworks, both of which companies' improvement programs I have ultimate respect for; but there is this incredibly exciting, vital, productive, job-creating—and as that recent study that was created last week suggested—highly export-intense series of a couple hundred million dollar companies that are a major, vital part of our economy that nobody knows about. You know, "Who is Nucor Steel?"

The only thing I can tell you about Nucor Steel is that it has, in fact, created about 175,000 more jobs than General Motors over the last ten years. That is, it created about 2,000, and General Motors lost 177,000.

The one thing that I always described myself as being proud of is my little company; have something like 24 people on the payroll. That means that I have created 3,000,024 more jobs than the Fortune 500 in the last seven years. I created 24; they lost 3,000,000.

Senator BAUCUS. You mentioned something about too many American firms going offshore?

Dr. PETERS. Right.

Senator BAUCUS. Could you expand on that a little bit?

Dr. PETERS. Yes.

Senator BAUCUS. What do you mean by that? What is the problem, as you see it, with the firms going offshore?

Dr. PETERS. The problem is twofold, and there is one particular part of it. The problem, which is my total frustration—and I even wrote something in my testimony that I will probably live to regret although I also wrote it in my book: I hate the idea of "domestic content" legislation, but I don't know how to get out of the problem.

The problem is that people go offshore because they haven't explored the opportunities onshore, either with American subcontractors or within their own firms. Let me give you one tiny example.

There is a very well run firm in Minneapolis called Medtronic, world leaders—including the Japanese—in the heart pacemakers. Medtronic, because of the chaos in health care financing and because of competitors from offshore, felt the harsh winds of competition about three years ago. They decided to really focus on it.

They have a division—and this is not a General Motors story; this is not a big behemoth that is way overweight around the middle—this is a little, already well-managed firm; and they had this little subsidiary called Promeon that makes the batteries, and a battery for a pacemaker is a very high technology product. They said to Promeon 36 months ago: "Fellows, you are really terrific, but we are going to go out to look for some other battery producer in three years unless you shape up. And we don't even know what shape up means." Well, shape up meant for this little American subsidiary, already well run, that for example they took their final assembly process in their plants—and the numbers are incredible—and reduced it from 30 days to 1 hour, which is to say that there was about a 1,000 to one improvement opportunity lying around.

They pulled $7 million out of a $10 million cost base within that subsidiary. Now, the little subsidiary of Promeon is making stuff more inexpensively than the Singaporeans or the Koreans or the Taiwanese or the Germans or the Japanese or the Swiss or the Swedes. How do we get companies focused on that? I hate the idea of domestic content; but I don't know how to get managers focused on the opportunity lying about for the taking.

There is one particular aspect of this that I feel desperate about, even more than the GM situations of the world; and that is my own hometown, Silicon Valley. I talked to an entrepreneur just a couple of weeks ago at a dinner, and he is so typical of the new breed; and I don't say that disparagingly; I say it with terror in my heart.

He has a terrific idea. He knows how to engineer it, market it, and distribute it. He has venture capital money; and without ever giving any thought to American production, he is going to go offshore to begin with.

Senator BAUCUS. Why?

Dr. PETERS. He believes that labor costs are lower and, most significantly, he believes the quality and reliability are higher.

Senator BAUCUS. Has he had experience offshore?

Dr. PETERS. Yes. He is an experienced businessman who has experienced offshore manufacturing vicariously, not directly.

Senator BAUCUS. I asked that because the American Business Conference recently came out with a survey of their CEOs about operating domestically or going offshore, and it was very interesting. Their survey showed that—actually, it was a survey of CEOs of major companies around the country.

Dr. PETERS. Right.

Senator BAUCUS. And their survey showed that those companies who are overseas now and have been overseas are less inclined to continue to operate overseas because their problems are more significant and more severe than they originally thought. Similarly, those who have not yet gone overseas think the grass is greener and that, with the lower labor costs, etc., they should go offshore.

It is interesting that, to those who have had the experience, it is not as much of a panacea as those who are not offshore.

Dr. PETERS. And on top of that, there is a problem which, to me, is bigger than all the others combined, which is almost never addressed; and that is, in the real world of commercial innovation, most of the practical innovation comes from the rich interaction between research people, factory people, sales people, franchisers, and so on on a day-to-day basis. And literally, if you take the heart out of the beast, manufacturing, the heart of that possibility for innovation goes away. And so, forgetting the cost issues and the scheduling issues and all that stuff, which I agree from my own observation, and the ABC study and the like, is not the panacea it was thought to be, even if you ignore all that, there's this huge innovation issue left.

Senator **Baucus**. I wonder if you could address that a little bit more because it does sound like, with the lower rates overseas, the firms want to go overseas. Let me just give you an example.

A couple of years ago, I was visiting a Hong Kong based American plant. It is a company that makes toys for kids. The wages that this company pays to its American employees, before fringe benefits, was something like $9.75 an hour. The same employees in Hong Kong in the factory there for the same company, performing the exact same functions, were paid—not $9.75—I think $2.50 an hour. This same company also had a plant in China—Mainland China. The wages there for the same functions were two bits an hour.

And they said the vast majority of their production is overseas in countries with low wage rates, and they ship the toys back and sell to American parents to give to their kids.

So, it seems on the face of it that it makes good bottom line sense for a lot of companies to go offshore.

Dr. **Peters**. Right.

Senator **Baucus**. A rejoinder, a rebuttal, that a lot of people have is that this trend has increased American productivity. Could you expand more generally on that point?

Dr. **Peters**. Yes. There are a couple, or three, things that I guess I would like to say; and one of them, I want to make sure I am not misunderstood. I made a very strong antigiantism argument. I am not making an argument for vertical integration. I am just saying that, if you are going to do your production and you are going to have an offshore component maker, look to Indiana, as well as the world of Singapore for component makers.

And I want to make that clear because, in fact, the biggest cause of the Chrysler Corporation's $500.00 a car cost advantage over GM is the fact that Chrysler is not highly vertically integrated compared to GM. Chrysler makes 30 percent of the value of the car; GM makes 70 percent. Chrysler looks like a Japanese company. It is a big joke that the Japanese talk about American hollow corporations; theirs are much more hollow than ours.

One of the reasons that their productivity per worker looks so high is, in fact, because they are not highly vertically integrated. Their big assembly plants are surrounded by a whole bunch of subcontractors for all practical purposes. So, my commentary here doesn't have to do with vertical integration. We are specifically talking about the offshore issue.

There are two points, I suppose. One of them is looking at what the real problems are, and this is the one that maybe scares me a lot. When it looked like—and maybe it still does—that the Gephardt amendment might go through and so on, The Limited stores is a classic example of a company that has extraordinary dependence on offshore factories. About 200 offshore factories produce most of their $3 billion in goods for them. When The Limited was looking for domestic suppliers, starting this March when the trade bill issue really heated up, The Limited found that they could find almost no American suppliers to meet their standards on quality and responsiveness. That is the frightening thing.

The Limited would argue, if Les Wexner, their chairman, was here, that his problem was not just, or even mainly, 25 cent wages over in China, but, in fact, when he needs to move from X to Y in terms of fashion change needs, China will react a lot faster than the United States will. And the textile industry is sort of trying to address that in the United States, but unfortunately, we are getting beat offshore, not just on price, but on quality and responsiveness.

There was a recent poll of Korean businessmen, and it showed that they preferred Japanese suppliers by a two-to-one margin over American suppliers, with an obvious rough equivalence in wage rates between the U.S. and Japan today. They said the problem with Americans was not the price issue at all—and this was before the crash of the dollar—but they said Americans offered low quality, lousy service, rotten responsiveness, and we wouldn't accept small orders. As far as I can remember from my business school education, those are about the only four major variables the businessman has.

So, I am concerned that the wages driving it—and one other point, in a way coming back to the heart of the matter.

I also do happen to believe that there is a continuing vital principle—again not an H.L. Mencken appropriate reference; not as simple as it is often interpreted by me, among others—and that is called comparative advantage. Maybe when one talks about some toys and some textiles, in fact the United States is not going to be the home of those products forever.

So, I think there are probably some things we should not be making in large terms. I completely agree that it is difficult to compete with inexpensive wages unless you believe the stories of that little battery subsidiary. And I really believe that lying on the table are 300 and 400 and 500 percent improvement opportunities.

Midlothian, Texas—Chaparral Steel. Chaparral Steel makes steel more cheaply than the Japanese. Chaparral Steel is so darned good that they are exporting from Dallas, Texas—Midlothian, that is about 40 miles away—to Germany today. U.S. Shoe, an American shoe manufacturer, is exporting to Germany today because they have increased their productivity by a factor of a couple hundred percent. That is part of the Rust Belt country—Cincinatti.

See, my terror, Mr. Chairman, is not that we are off the mark on quality or responsiveness or productivity by five or ten or fifteen percent; but that, of course, that labor looks good in Singapore and Taiwan because how can you beat this stuff?

I would just kind of hate to pick on these people if they didn't deserve it so dearly; but how do you fight this one?

The NUMMI story, and I was lucky. I got a sort of a back-door copy of the first extensive analysis that was done of NUMMI, and they go through all the people-oriented stuff. And then, at the end of it—and this is the kind of line that I find most telling—one of the managers at NUMMI pointed out one other area of comparison. They were talking about the two joint venture partners. When top General Motors executives visit Fremont, California—that is the NUMMI plant—they arrive in chauffeur-driven limousines or many times in a helicopter. When high officials come from Toyota, they are picked up at the airport by an employee driving a Nova. That counts. I don't know how you write legislation to deal with that.

Senator BAUCUS. What about the corporate raiders? A lot of folks say—these CEOs at major companies—that raiders force CEOs to look at the short term, that is, to build up the cash positions to protect themselves so they are not overtaken, instead of enabling CEOs to take the longer term look and so forth. That is somewhat their rebuttal.

Dr. PETERS. Yes.

Senator BAUCUS. Now, you say, I think in one of your books: Two and a half cheers for Boone Pickens. [Laughter.]

Dr. PETERS. I didn't go the whole way, please note. [Laughter.]

Senator BAUCUS. The point being that it is good to keep these CEOs on their toes. It is good for them to be pressured into trying to be more efficient so they are not open to hostile takovers, as opposed to friendly takeovers.

Yet, there is a feeling in the argument they make, namely, that it does force a lot of CEOs to think short term and focus on their quarterly reports to fend off the raiders, which takes away time and resources for the longer term. What is your response to that?

Dr. PETERS. CEOs seem to have a list of about 8,427 reasons that they are forced to look short term and can't invest in people and quality; and I think it is a big bunch of baloney—that is the answer. I acknowledge that the American system emphasizes short-term orientation. I am not sure that is all bad. I do not think that, when you finish these hearings, were these to be the ultimate hearings on competitiveness or the ultimate story on competitiveness, and were you to come up with the perfect answer for America, I don't think it would be the Japanese answer. I think we are fundamentally different; and just because I happened to have lived here all my life and like the place a lot, I kind of like it the way we do it in some respects.

I think our answer will be uniquely American. I believe, as I said, that the brightest star in the American sky relative to the transformation is the openness; and I am scared to death more so than most people about October 19th because I don't think we understand it; nobody understands it. The brightest star is the openness and the vitality of our capital markets. That is the way that we choose to do things.

That is the somewhat more Adam Smith approach than the meaty Ministry of Finance approach, which is taken in Japan.

I don't have any patience with that comment by the chiefs of the Fortune 500. First of all, I think we overemphasize their role much too much. There are more than 500 companies in this country, and I think it would do all of us good, starting with myself—I mean, every time you hear what is General Motors doing? Frankly, I don't give a damn what General Motors is doing. I am much more interested in how we help Weaver Popcorn continue to double its sales.

I am much more interested in how we continue to help Nucor Steel, Chaparral, and Worthington Industries in the steel business, who in fact took advantage of the new technologies and people and so on.

Senator BAUCUS. What about green mail?

Dr. PETERS. You know, I am not a technical expert. I think green mail stinks.

Senator BAUCUS. So, what you are saying is that, yes, there are some abuses?

Dr. PETERS. Of course. Yes, sir.

Senator BAUCUS. And we should limit abuses, namely green mail, the golden parachutes and some other techniques that management sometimes indulges in; but on the other hand, keep the pressure on them?

Dr. PETERS. Precisely. Let's eliminate green mail, but let's not tax the raiders to death so they don't keep that pressure on. It is the same point I made, and you are the one who made it by starting with Menkin. It is the same point with ESOPs. ESOPs have been abused. There is no issue about that. You can find dozens of examples of ESOP abuse; and yet, I am a strong supporter of ESOPs. And the question is: How do we support them more while cleaning up the down sides?

And I think fundamentally it is the same deal here with the raiders. How do we keep the openness?

I don't like the solution, but in fact, the corporate world is a lot like the world of politics; and that is about the art of the possible. And right now, the most significant thing required in corporate America is high intensity pressure on our biggest firms. There is a lot of vitality in that mid-size and smaller business sphere, but frankly I am not.

My point is—and I am not consistent with the ABC on this, and I am not consistent with my good friends at Inc. Magazine or David Birch of MIT, or George Gilder, who says the answer is that all we need are a jillion tiny businesses. Maybe that is true, but that is not a happy answer for all the millions of people who are employed by the Fortune 1,000 or the Fortune 1,500.

So, I think we have a great responsibility to push hard on the transformation of our biggest and sometimes oldest and stodgiest firms as well as unleash the smaller part of the economy.

Senator BAUCUS. Dr. Peters, you have been terrific, and I appreciate your time here. We could go, frankly, for the rest of the day on this; but in the interest of time and because we have other terrific witnesses here, we are going to have to close this portion of the hearing. This will not be the last time that we will address this issue, and I know it is not the last time that you will appear before Congress and have more ideas. We do thank you very much for your valuable contribution.

Dr. PETERS. Thank you, Mr. Chairman.

Senator BAUCUS. Thank you. All right. Our next witnesses are a panel of Mr. Paul Huard, Vice President for Taxation and Fiscal Policy of the National Association of Manufacturers; Mr. Larry Langdon, Director of Tax and Distribution, Hewlett-Packard Company, testifying on behalf of the Emergency Committee for American Trade; and Dr. Harvey Bale, Jr., International Public Policy Manager for Hewlett-Packard Company, testifying on behalf of the Council on Competitiveness.

Gentlemen, we are very honored to have you here. Mr. Huard, why don't you begin?

[The prepared statement of Dr. Peters follows appears in the appendix:]

STATEMENT OF PAUL R. HUARD, VICE PRESIDENT, TAXATION AND FISCAL POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, DC

Mr. HUARD. Thank you, Mr. Chairman. I am pleased to be here this morning to present the Association's views on the interrelationship with tax policy and international competitiveness. I must begin, however, by emphasizing our belief that the single-most important step that can be taken to improve U.S. trade competitiveness is decisive action by the national Government to reduce Federal deficits through spending control and without tax increases.

This can be achieved by slowing the growth rate of Federal expenditures in all areas of the budget, with no exceptions. Wherever feasible, program outlays should for the short run be held at or near present levels. In the case of entitlement programs that are indexed for inflation, the indexing rate should be permanently capped at something less than 100 percent of the full rate of inflation, with no program—not even Social Security—exempted from this long overdue reform.

Once the budget is in or near balance, the growth rate of overall Federal expenditures should not be permitted to exceed the growth rate of the GNP.

Let me turn now to the subject of taxation. As a result of tax policies recently put into effect, we have raised the cost of capital in the U.S. by 15 to 20 percent. Depreciation allowances have been reduced to the point where they do not even compensate for economic depreciation, much less provide any incentive to invest in productive plant and equipment.

By 1990, the share of GNP going into business fixed investment will plummet to the lowest level in 25 years. Personal consumption, on the other hand, will hit a 40-year high, reaching levels not seen since 1950. If we are to improve competitiveness and productivity, the new Federal tax law's extreme bias in favor of consumption and against savings and investment must be reversed. It most assuredly should not be made any worse than it already is, which is one good reason for discarding the antibusiness tax bills recently developed in each of the tax-writing committees of the Congress.

Since it nevertheless appears that Congress lacks the requisite will to deal with the deficit problem without raising revenues, NAM recommends that any such new revenues be derived in the short run by lowering the capital gains tax rate and, over the longer term, from a transaction based consumption tax applied at a single uniform rate to the broadest possible base of both goods and services. Such a tax should be separately stated so that it is readily identifiable by taxpayers, who ought to know what they are paying for the cost of Government.

It should be border-adjustable so as not to burden exports as do our present payroll and corporate income taxes.

Offsetting adjustments should, of course, be made to deal with the problem of regressivity. In this regard, a refundable income tax credit appears to be the most efficient technique. We also believe a significant portion of any new revenues derived from a consumption-based tax should be used to reduce existing Federal corporate income taxes.

The average effect of corporate tax rate is clearly excessive, having now reached the level where it is more than triple that of individuals. While the theoretically correct approach is to repeal the corporate income tax, this may well be politically impossible. There are, however, other desirable improvements that would help considerably, such as proper integration of the corporate and individual tax systems so that earnings paid out to shareholders are not doubly taxed and a restoration of a better capital recovery system.

It is perhaps somewhat daring to suggest what is needed is more taxes on consumers and less taxes on corporations, but that is what the facts plainly point to. The personal income base is more than twelve times as large as the corporate profits base. It is, in the end, folly to try and pile the entire burden of deficit reduction on that narrow portion of the income base that represents employers and producers. Moreover, suggestions that the Federal deficit is attributable to corporate tax cuts are demonstrably false.

Corporate taxes, as a share of GNP, have indeed shrunk for the very good reason that corporate profits, as a share of GNP, have shrunk. And with regard to the much-maligned 1981 tax cuts, I note that these have been more than fully reversed in the case of corporations while individuals have retained virtually every penny of such cuts.

Those who are inclined to blame the deficit on the 1981 tax cuts are entitled to their opinion, but I wish they would follow that opinion to its logical conclusion.

This concludes the summary of my remarks. When the other witnesses' presentations have also concluded, I would be glad to address any specific questions you might have.

Senator BAUCUS. Thank you, Mr. Huard, Mr. Langdon.

[The prepared testimony of Mr. Huard appears in the appendix:]

STATEMENT OF LARRY R. LANGDON, DIRECTOR, TAX AND DISTRIBUTION, HEWLETT-PACKARD CO., PALO ALTO, CA, TESTIFYING ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. LANGDON. I am Larry Langdon. I am Director of Tax and Distribution at Hewlett-Packard Company. I am testifying this morning on behalf of ECAT. HP, as you know, is a major designer and manufacturer of electronic products and systems for measurement and computation. For the fiscal year that ended last month, we had over $8 billion in world-wide sales, of which about 50 percent is international.

HP's world-wide R&D is approaching $900 million, of which about 90 percent is in the United States; and that equates to about 12 percent of our sales. This last year, we exported about $1.4 billion, and we are ranked among the top ten to fifteen exporters from the United States. HP has 82,000 employees world-wide, of which about 53,000 work in the United States.

I am also representing ECAT, which is the acronym for the Emergency Committee for American Trade. ECAT was formed in 1967, and ECAT continues to support measures which expand international trade and investment. Its members are the leaders of sixty large U.S. firms with extensive overseas business interests, and they are the largest U.S. exporters and investors in foreign markets. They have world-wide sales of more than $700 billion, and they employ more than five million people.

Let me address the international competitiveness issue, which is going to be the focus of my tax comments. Harvey Bale obviously will cover this in greater detail later on; but the President's Commission on Industrial Competitiveness that was chaired by John Young of HP defined competitiveness as "the degree to which a nation can, under free and fair market conditions, produce goods and services that meet the test of international markets while simultaneously maintaining or expanding the real income of its citizens."

So, our primary concern, as was the Commission's, is competitiveness as it affects a range of factors, of which no one predominates; and that was clear from Dr. Peters' remarks. Obviously, the strength of weakness of the dollar the size of the Federal budget deficit, inflation rates, monetary policy, trade laws, tax policies, and other factors all have an impact on our competitiveness.

Thus, improving our international competitiveness will require action on a broad range of issues, not just one or two. And certainly, the trade legislation now being considered by Congress is of critical importance, as are efforts to reduce the Federal budget deficit. Let me move to tax matters.

Tax policies undoubtedly influence our international competitiveness; and first, I would like to talk about the rate reduction. ECAT endorses wholeheartedly the significant cut in corporate income tax rates by the Tax Reform Act of 1986. And I would like to stress that every effort should be made to preserve these low rates. Low rates clearly help our U.S. international competitiveness position.

Second, let me talk about incentives and disincentives for technological innovation. R&D is the lifeblood of high technology companies and the electronics industry. However, R&D is critical to such industries as pharmaceuticals, aerospace, defense, and many others. Technological advances are being applied to other industries and services such as automobiles, banking, and telecommunications, thus having great effects on the productivity of many sectors of the economy.

Extending the R&D credit through 1988 was a positive development. ECAT encourages the Congress to make the R&D credit a permanent feature of U.S. law. Additional resources which could be channeled to R&D efforts over a period of years with a permanent R&D credit in place clearly would add to our ability to compete. The R&D allocation rules under Section 861-8 of the Income Tax

Regulations create a tremendous disincentive for U.S. companies with foreign operations to conduct R&D in the United States. The rules are complex, but in essence they disallow a tax deduction for a portion of a company's R&D conducted in the United States.

Therefore, the current regulations create an incentive for a company to move its R&D activities outside the United States.

Mr. Chairman, you and Senator Wallop have been leading proponents of legislation to repeal the 861-8 R&D regulations and have played a key role in the development of a compromise that is supported by the Administration, the Treasury Department, industry, and members of the Finance Committee and the Ways and Means Committee. We hope the compromise, which is included in both the House and Senate bills as part of budget reconciliation, will be adopted this year so that significant disincentives for conducting R&D in the United States, caused by the 861-8 regulations, could be substantially reduced.

Another important consideration is that manufacturing jobs most often are created near the location where R&D is conducted. Thus, by encouraging R&D, we can promote manufacturing as well. Our competitors around the world are recognizing the importance of R&D incentives in their tax systems, and this is true in Australia, the U.K., and Canada, which have substantial incentives for R&D.

Let me move to the issue of exports. For over 60 years, U.S. tax laws have contained a provision that treats part of profits on exports as foreign source income, sometimes called the Title Passage or Export Source Rule; and this rule is only of benefit to exporters with substantial foreign tax liabilities, either directly or indirectly through foreign subsidiaries. The export source rule was actively debated during tax reform and was preserved for companies that export products to the United States. The conference report directed Treasury to study this provision, and a recent study by Gary Hufbauer of Georgetown University stated it was believed that the source rule would lead to a reduction of exports if it were repealed between $3.9 and $5.4 billion, which would result in a loss of between 115,000 and 160,000 jobs in the United States.

So, it is very important that Congress retain this provision as part of the ongoing legislative package.

Fourth, I would like to talk about export financing. The 1986 Act has a very limited exception to these burdensome new foreign tax rules for certain types of export financing; and it is understood that you, Mr. Chairman, and Senator Roth are sponsoring legislation to significantly broaden this exception to cover all export financing activities. I commend you for this initiative and hope that Congress will act on this proposal this year.

Fifth, let me talk about the international provisions of the Code relating to deferral and double taxation. This has been part of our Code for a number of years, which provides for deferral of taxation of income on foreign subsidiaries, with the exception of tax haven activities—the so-called Subpart F—and, second, the use of the overall foreign tax credit to avoid international double taxation.

ECAT historically, for a number of years, has been opposed to the elimination of deferral; and yet, deferral has been severely eroded by the Tax Reform Act of 1986, which reduced the Subpart

F threshold from 10 percent of gross income to the lower five percent or $1 million. And under these new rules, there will be current U.S. taxation of this income, and this de minimis rule and the complexity of it have resulted in a severe distortion of taxation of income currently and complexity with regard to our Tax Code.

Another aspect of the new law is the so-called PFIC rules—passive foreign investment company provisions—which were adopted, which also severely curtailed the deferral concept; and we would recommend that these rules be reversed, revised, and liberalized so that income of foreign subsidiaries would not be currently taxable in the U.S.

This is really an international competitiveness issue because, in Japan, Germany, Italy, Belgium, the U.K., and Canada, similar provisions do not exist. The 1986 Act also added a great number of baskets which provide for a computation of foreign tax credit limitation, and these have resulted in a measurable erosion of the overall foreign tax credit limitation concept that create a great likelihood of U.S.-based companies to be subject to international double taxation. It has also resulted in a great deal of complexity.

There is another provision that is currently pending as part of the effort to raise taxes called Income from Imported Property, or the so-called runaway plants. This is part of the House Ways and Means Committee proposal, not part of the Finance Committee's; and specifically, it would tax income currently earned by U.S. companies which have foreign subsidiaries that have to import the product into the United States. ECAT and HP are strongly opposed to this provision because it places U.S.-based companies at a significant competitive disadvantage in that it repeals deferral—a fundamental principle of U.S. taxation—and it has the unintended consequence of not understanding the global nature of international economic competition.

And very quickly, the example would be in Singapore and Malaysia, where we would have a Japanese competitor down the street from us where we have plants; and they would be able to import products into the United States without tax while we would be fully taxed upon those earnings.

So, let me very quickly summarize my five points. One, we need to continue to keep our low corporate tax rates in place. Two, we need to continue to have incentives for R&D in the United States with a permanent U.S. credit, solving the 861-8 R&D allocation issues and provide for favorable depreciation of R&D equipment. Continue export incentives, such as the FSC, the export source rule, export financing, and stop the erosion of the principle of deferral with regard to the issue of income from imported property, the PFIC rules, and thereby giving foreign competitors an advantage over U.S. companies and selling in the U.S. marketplace.

And we should continue to watch the multiplication of so-called baskets, which threaten double taxation.

I will be glad to answer questions after Dr. Bale testifies.

Senator BAUCUS. Thank you, Mr. Langdon. Our next witness is Dr. Bale.

[The prepared statement of Mr. Langdon appears in the Appendix:]

STATEMENT OF DR. HARVEY E. BALE, JR., INTERNATIONAL PUBLIC POLICY MANAGER, HEWLETT-PACKARD CO., ARLINGTON, VA, TESTIFYING ON BEHALF OF THE COUNCIL ON COMPETITIVENESS

Dr. BALE. Thank you, Mr. Chairman. It is a pleasure to be here today, after spending some dozen years in the Office of the U.S. Trade Representative appearing before this committee and you, sir, speaking for the Administration. For the first time I am here speaking for the private sector, specifically the Council on Competitiveness, a private sector organization composed of chief executives of the corporate, labor, communications, and academic communities.

The council is chaired by the present President and Chief Executive Officer of the Hewlett-Packard Company, Mr. John Young.

I think that your task of identifying and exploring the various facets of competitiveness is to be commended. Obviously, there are a number of competitiveness issues: human resource policy, trade policy, competition policy, innovation and productivity policy. And perhaps we could add to one of the more fundamental issues that Dr. Peters addressed this morning, and that is the issue of moral suasion. How do we get the private sector to behave in a fashion that reflects the national interest of maintaining a high standard of living and an even balance in our external accounts?

I should say that perhaps an idea comes about from the U.K., where I spent last week, and I learned that our U.K. affiliate, Hewlett-Packard, Limited, received this year the Queen's Export Award. Perhaps we need to be doing more in the recognition field in order to encourage further small and medium and large businesses that are trying, in fact, to export abroad.

But this morning I would like to highlight for you the Council's activities in the area of fiscal policy. The Council has determined that a top priority should be to explore the issue of fiscal policy and its implications for our competitive position in the world economy. Of course, today all eyes are focused on the budget summit.

The Council's interest grew out of the belief that, while a significant consensus exists on the necessity of a credible deficit reduction, there is little agreement on the appropriate mix of fiscal policy tools, both spending and tax, to achieve deficit reduction in the long run. The issue is further complicated by the fact that, in developing a package, consideration must be given to both the short-term economic implications of spending cuts and revenue increases, particularly as the U.S. and world economies seem to beginning to slow down, and to efforts to restore U.S. competitiveness.

We envision that the Council's work could be useful in two respects. The first is to help build a broad-based consensus for the difficult political choices necessary in coming years, as well as these months ahead, to achieve sustained, credible budget deficit reduction. The second is to help ensure that, in crafting the tax and spending components of U.S. fiscal policy, restoring our competitiveness becomes and remains a major policy objective.

The Council has established a senior level task force to explore the issues of what constitutes a pro-competitive fiscal policy. Our first task is to elaborate the linkages between the U.S. fiscal policy and the status of the current deficit—the declining competitiveness specifically as it relates to trade deficits—and declining productivity.

Mr. Chairman, the existence of large and protracted Federal budget deficits in our low saving society has contributed to two of the clearest indicators for a declining competitiveness: the large trade deficits we have run since 1981 and decreased levels of investment which contribute to declining productivity. The United States has historically had a low private saving rate, one lower than its major industrial trading partners.

During the period from 1973 to 1985, U.S. gross saving averaged approximately 19 percent of our gross domestic product. Comparable figures for our major trading partners range from 18 percent in the United Kingdom to 33 percent in Japan. In the 1980s, our saving rate fell even further, averaging 17 percent between 1981 and 1986.

Senator BAUCUS. You are talking about national savings rates?

Dr. BALE. National savings. Right. We would include in there the state and local levels as well, which were counted in this calculation. As a nation, we just do not save enough for both domestic investment needs and a large budget deficit at the Federal level. The role of the Federal budget deficit on saving and investment flows is profound.

There is a significant gap between what we as a nation save and what we invest. The key differential factor in the equation is the Federal budget deficit. It serves to reduce the amount of saving available for domestic investment.

To date, the saving shortfall in the United States has been made up by foreign capital inflows. These inflows have allowed us to consume more than we produce. This practice is not without serious cost to the economy. The most significant problem is that the enlarging net inflows of foreign capital in recent years are the mirror image of growing current account deficits. These deficits, which were in the $150 billion range in 1985 and 1986, have arisen through interest rate and exchange rate adjustments that have been driven in part by these deficits.

As important from the competitiveness perspective as the effect of the budget deficit on trade deficits is their effect on the investment in the United States. The budget deficit in conjunction with low private saving has increased the cost of capital for business investment. One estimate is that in recent years real interest rates would have been three to five points above where they have been had not there been the large capital inflows experienced in recent years.

Of course, in recent months we have seen a withdrawal of the private sector abroad from the U.S. capital market.

The level of domestic investment becomes more important when compared to investment levels of our major trading partners. Between 1973 and 1985, we devoted almost 14 percent of our GDP to investment, while all of our trading partners devoted considerably more, with Japan topping the list at 24.2 percent. Interestingly, these same countries experienced considerably higher productivity growth rates than the United States during a comparable period.

To increase our productivity, investment levels in the United States need to be considerably increased. Implications of the trade deficits and lower levels of investment, both of which can be related to the budget deficit—the Federal budget deficit—can be summed up as follows.

First, the accumulation of several years of current account and merchandise trade deficits has transformed the United States from the world's largest international creditor to a net international debtor with a foreign debt of about $264 billion at the end of 1986. If, as estimated, the U.S. debt held abroad reaches $800 billion in five or six years, servicing that debt will cost at least $50 billion a year.

Until we run substantial trade surpluses, the foreign debt will continue to accumulate. I have seen estimates, Mr. Chairman, that we will need to turn around our manufacturers' trade deficit by about $200 billion to achieve the kind of level of trade surpluses that are needed to avoid catastrophic financial burden that we will face in the 1990s.

Second, large merchandise trade deficits affect overall economic growth levels, and they have caused serious dislocation in certain sectors of the economy, particularly manufacturing.

Third, U.S. economic policy-making, both fiscal and monetary, is constrained by a need to attract foreign capital to finance the saving-investment gap. At the same time, we have become increasingly vulnerable to changes in the economic policies of foreign countries and investor perceptions of the economy, both domestic investors who may flee abroad, as well as foreign investors who may decide to go home.

Aside from the implications related to our increased dependence upon foreign capital inflows, there are other competitiveness problems associated with running large and protracted budget deficits. One, budget deficits limit our ability to respond in the event of a serious recession. Second, budget deficits, by competing for a smaller pool of private saving, prevent the United States from undertaking the type and level of investment necessary to increase productivity and stimulate new product development.

The preceding illustrates quite clearly, I believe, the role of the Federal budget deficit in America's declining competitiveness picture. Our next step, which will be the core of the project, will be to explore various combinations of spending tools to determine which best meet our goals of reducing the deficit and enhancing American competitiveness.

We plan to look first at the spending side of the ledger, both in terms of where additional spending cuts might be made in the future without harming our competitiveness and where additional funding may be necessary to support our competitiveness objectives. We are proceeding with the notion that spending cuts are possible but recognizing the difficulty of the task, that some reprioritization of spending may be inevitable. Interest payments, which constitute a growing portion of the budget deficit, cannot be touched, of course, in the short term. After a rapid rise in the early 1980s, defense spending has declined in real terms over the past two years, though more may be done there.

Discretionary spending, which includes funding for a number of the most important competitiveness programs, is down to 1960 levels. The entitlement programs, which constitute the lion's share of the Federal budget, pose their own set of political problems. On the tax side, we are being guided by the assumption that the principal goal of any tax increases we are considering is deficit reduction. Two approaches to taxes are being explored.

The first is what could be called a piecemeal approach involving a look at a variety of changes in the current tax system, including excise taxes, the gasoline tax, and others.

The law should be explored in making major revisions to the Tax Code, including the possibility of a consumption tax.

The project represents a considerable undertaking for the Council; and in attempting to develop a pro-competitive fiscal policy, we will face many of the same pressures that you in the public policy arena face. We hope that we can capitalize on and help encourage further development of the mandate from the markets and the American public to significantly reduce this enormous deficit.

Mr. Chairman, it is clear that a credible deficit reduction must be a national priority, both today and in the future. Attention must continue to be focused on this important but often overlooked reality, that is, the relationship between the budget and our competitiveness, and these hearings are a useful step in that process.

We hope that the work of the Council will also contribute to this important policy debate, and we look forward to working with you closely in the future in this area.

Senator BAUCUS. Thank you, gentlemen.

[The prepared statement of Dr. Bale appears in the Appendix:]

Senator BAUCUS. I am somewhat struck in listening to you about the essential difference in the approach that you take compared with the prior panelist, Dr. Tom Peters.

As I listened to you, I heard you say that we should reduce the Federal budget deficit, help promote lower interest rates, and create greater savings pools. In addition, I heard Mr. Langdon address the export source rules, tax reform, the PFIC problem, and export financing, which helps American companies retain earnings.

And we hear talk about the need for a trade bill, although there is less talk about that these days, at least less than say a year ago. These are issues which focus on numbers and tax policy and savings and investment and so forth; and they are very different from the points that the prior panelist, Tom Peters, was making. He said that this is a people issue, that management has to get off its duff and get out there and hustle more and learn foreign languages, learn more about quality, learn how to motivate people. He said we should invest more in people and profit sharing and ESOPs and so forth. They just have to get out there and hustle more so that we produce better products with more attention to quality and do all the things we need to do just to go out and meet the competition.

I would like you to address what you think the right mix is here. Obviously, it is both. Obviously, we have to increase our national savings rates. Obviously, we have to reduce the deficit. Obviously, we have to have a tax policy which enables American businesses to raise money.

What is the right mix here? Let me ask the question a bit differently. How much of what Tom Peters is saying do you think is right? That is, even though we have to get the budget deficit reduced very quickly, and even though we have to have a higher national savings rate, how much in your judgment of what Tom Peters is saying is right? That is, even if we pass a trade bill and eliminate some of the more"protectionist"provisions, and even after the budget deficit is significantly reduced, is that going to solve the problem?

Or is Tom Peters right in saying that, after all that is taken care of, you bet, we have a real problem here in America; and he begins to touch on some of those things we have to do? Could you just tell me in your best judgment how much, in addition to the problems you are talking about, is also along the lines of the problems that Tom Peters was suggesting? I will just go down the line here. Mr. Huard, we will start with you.

Mr. HUARD. I would tend to agree with a large part of what the prior witness said. As a practical matter, we have to do it all. We have to get rid of protectionism. I think we have to have a reduction in the deficit. We have to have a more balanced tax policy vis-a-vis the way we treat consumption and the way we treat savings and investment.

And I think we have to have an increased focus on quality. We have to have better education, more people orientation. Frankly, I think we have to do all of these things. I don't think doing one, but not the other two or three, is going to solve our problem. I think we have a three, four, or five legged stool here. Essentially, again, I would agree with a large part of what Dr. Peters said.

Senator BAUCUS. Mr. Langdon?

Mr. LANGDON. I would also agree with what Tom Peters said. However, I have difficulty with regard to the role of Congress concerning the people and quality issues which he addressed so effectively. I am not so sure that that these issues can be legislated from either end of Pennsylvania Avenue.

I have been with HP for ten years, but before that, I spent eight and a half years with the Ford Motor Company; and we went through a series of struggles there, but you will notice that right now Ford Motor Company is doing as well as any of the American car companies. You start reading the articles on why that has occurred, and you look at two key issues. One, they have developed a quality product, the Taurus and Sable models. They did it by relying on their people and getting cooperation between the marketing R&D and manufacturing people on the management side and the UAW on the other side. And quite frankly, if Ford can do it, GM can do it, too; and I am not so sure that, even with the best efforts in Washington, that can happen.

But I think that American business across the board needs to become more competitive and more people-oriented and more goal-oriented with regard to the issue of quality. I guess the issues that many of us addressed tended to be the issues where Congress can play a very important role. I think that the 1986 Tax Reform did a good job of evening the playing field within the U.S. so that, within industry groups, capital can flow more adroitly without tax incentives.

But I think that we have to be careful that we realize that internationally we are in another competitive environment and that we are dealing with two factors. One, we need a presence abroad in order to be effective in selling our products abroad; we cannot just sell our products at X U.S. factories. We need a presence abroad, and we need to make sure that our tax policy supports that.

And then, in addition, we need to realize that we are dealing with foreign-based competition, which doesn't necessarily operate in the same tax regime that we have. Part of the corporate raider syndrome we have seen is that foreign-based companies have invested in U.S. companies, and there has been a tendency, in certain respects, to emasculate those U.S. companies and move the foreign part of the operations offshore. We should make sure that U.S.-based companies can continue to compete with those acquisitions in an effective manner by making sure that our rules with regard to U.S. based companies are as competitive as the rules they operate under.

Senator BAUCUS. Dr. Bale?

Dr. BALE. I thought Dr. Peters presented a very healthy and useful perspective on this, putting much of the blame on the business community, mostly the private sector—labor and management. I did leave his train, though, when he began to address the problem of overseas production. This is a phenomenon which, earlier in his own statement, recognized that to survive in today's world—picking up a point that Larry Langdon made—you have got to be international. This involves exports, and Hewlett-Packard and other major technology companies are exporting much higher than the average eight percent, which is the export-to-gross national product level that we have. HP, exports twenty percent of its output. Other companies, like Boeing, are exporting almost 50 percent of their output.

Now we are faced with performance requirements abroad. There are informal requirements, that is, to know the market you have got to be there and sell there. The European Community is a classic example. They also have a common external tariff, discriminatory public procurement policies, and informal games that I found in my trip last week where we, as a company, had to locate a plant in a particular country. Otherwise, we were told bluntly: You are not going to sell here. Now, that is a trade policy issue; and that, to me, makes trade policy a very important issue for our company.

It makes the trade bill a useful exercise if one can be crafted without the strange bells and whistles that are currently a part of it. Thus, there is a sting policy element. The policy element provides the framework in which the private sector acts; and if we don't have a good, open environment overseas, or if we don't have a competitive environment at home, with appropriate human resource planning and a competition policy and R&D incentives, then we can have the greatest competitively minded folks in the world, and they will do something, but they won't do an adequate job.

Senator BAUCUS. I think Tom Peters' point was that one does have to go overseas. In fact, in reading one of his books, he makes a big point of how it is a necessary component to be internationalist because you have to go over where the action is to learn what is going on and what is happening, certainly if you are going to sell in that market.

I think, though, he was also saying that there may be too much of a tendency for some American firms to go offshore looking for lower wage rates when, in fact, there are other ways to get a better mix between domestic production and foreign production.

I would like to shift gears here now a little and address the degree to which the Federal Government can help address some of these management incentives. You make a very good point, Mr. Langdon, in saying that the Government should get involved in what it can do without messing things up, but not get involved in those other areas that tend to mess things up. You cited Ford Motor Company as an example where a major American manufacturer, basically on its own, decided to pay more attention to quality and is doing quite well; and I think that is accurate.

Several points come to mind, that is: What if, by some objective standard, American companies begin to address quality on their own? Should the United States Government help encourage management to pay more attention to people, that is, its employees? Should the Government try to encourage more employee motivation with some kinds of tax incentives, if you will, to companies that set up profit sharing plans or to help promote ESOPs, or at least ownership of employees in a company, or maybe more bonus payments? There are some academicians who think the Japanese bonus system helps to encourage productivity in Japan. And one final point, I am sure you have read this book called Acacia; it is a book by two Americans about Japanese corporations. The thing that struck me in that book is that, in Japan, the goal of Japanese management is not the greatest rate of return to its shareholders; it is not the greatest rate of return on its assets. The goal of Japanese management by far with most Japanese companies is what is in the best long-term interests of its employees. They know that if they are worried about the best long-term interests of their employees, their employees are going to produce. Their employees are going to hustle in trying to meet the competition, if you will.

I think that is the basic point that Tom Peters was making, too. It is people that count. It is customers that count. Can't the Government in some way help to encourage management to pay more attention to customers and people? Or should we just go home and go back to our constituents and not run for office again? Is there an appropriate role here for Uncle Sam and for the Congress to encourage management to pay more attention to people?

Mr. LANGDON. I think there is, and certainly I resonate all of the themes that Tom Peters articulated in that regard; and I think that HP and a number of companies have tried to do that. The key issue is: Can we come up with a vehicle, a nomenclature, a way of holding that out as the key example?

I think Tom Peters and his colleagues need to be commended with regard to, quite frankly, advertising that very graphically in all of their written works—the videos and everything else that they participated in. And as you can tell from how well he has done with regard to his books, people are beginning to listen a little bit.

I would also suggest that we carefully address some of these people issues with regard to the Tax Code. For example, as you may realize, we have a disincentive for companies with regard to participation in employee training because, in effect, the one or two year moratorium is going to run out on employee training where, in effect, companies can give tax free treatment to employees so that they can further their education. We need to readdress that issue and make sure that companies are somehow forced to get them to think aggressively in the direction of getting their people better trained. The ESOP issue, the 401(k), the employee stock purchase plan—these are good things to address.

We have cash profit sharing at HP. We think it is a good idea. It gives us a competitive advantage over the folks who don't have it, quite frankly. But then, maybe Congress should encourage folks to move in that direction as well since it does have many of the desired consequences.

I think we do have a more generic problem of a crisis of leadership in this country. I think that it is good that you are having these hearings because you are dealing with, I think, a broader issue which is leadership and the role that the Congress, the President, and the other people in the public sector can play in providing this leadership.

So, I commend you for addressing these issues. I think they are very key to our survival.

Senator **Baucus**. What about savings rates? You know, there is a lot of talk about savings rates, that is, we have a low savings rate. Dr. Bale, you mentioned that. I will give a plug here. Last night I was reading an article that is serialized now in The New Yorker; it is by William Greider. It is called "The Annals of Finance." It is a three-part series; I know he is going to write a book. [Laughter.]

Senator **Baucus**. You can just smell it by reading the article. But I was astounded to learn that during the war—I think it was 1942 or 1943—personal savings rates in America were 25 percent. That was during the war, I think in 1941 or 1942. You know, we always say historically we have always had low savings rates. Well, we have a short memory on some of this, too. I wasn't around then, but we Americans did save during a time of crisis; when we had to save, we did.

I grant that the biggest problem for national saving rates is the budget deficit, which eats up—I think—two-thirds to eighty percent of private savings. So, there is little savings left in America. Let me ask you this: Can the Government still help constructively to encourage private savings? Assuming we take sufficient action on the Federal budget deficit and get rid of the dissavings on the public side, on the private side are there appropriate ways to help encourage savings? You know, we had savings bonds years ago; I think they helped. Some suggest IRAs or ITs, individual training accounts. Mr. Langdon mentioned 401 (k)s and so forth.

Dr. **Bale**. Perhaps I will take that on initially. Your reference to the war period—not having been there myself also—gives me only what I have read. There was a rationing system there, and it points to something which is an element of crisis that forces events here. We could see that again if inflation simply took off and the Government began to clamp down with wage and price controls. Then one could have what the economists call forced saving. That is not desirable, and of course, that would not be an end to be sought.

Having just visited Germany, we saw there quite a bit of wealth and saving. And it is interesting that, at the same time, there is quite a bit of debate over lengthening the shopping hours in Germany. In many European countries, as you may know, there are strict legal limitations on shopping hours. To some extent, they experienced what we experienced during the war: an inability to consume; not an inability by way of rationing, but simply an inability in nonworking hours to travel to the shopping center and engage in a high-consumption activity. Certain elements of this are cultural, which I don't think we will certainly be able to return to modify it except in an extreme crisis.

But it was a pity to see the change in the IRA provision to basically coming very close to eliminating its benefit; and perhaps we need to look at incentivized IRAs: incentives to increase saving, not necessarily base a tax-free return on the level of savings, which has allowed individuals in the past to shift accounts, but something which provided a saving incentive comparable to the incentive in the R&D tax credit. The idea is to increase R&D spending.

I should also say that, going back to the consumption tax, back in the original Presidential Commission on Industrial Competitiveness, which was also headed up by John Young, there was a discussion in here of trying to restructure the tax system to develop a tax code that would work more effectively to stimulate saving. And here, there was a recommendation that there be a "reduction in the bias against saving and investment for greater reliance on taxation of consumption, but keeping the progressivity to ensure fairness."

Some mix of consumption taxes and income taxes, perhaps, is a major element in a policy that would have beneficial impact on exports, on revenues, which of course goes to the issue of national savings, as well as investment.

So, there are some things to be done. It is going to be very difficult. We are in the early stage in our Council work; and hopefully in three or four or five months, we will address some of the issues that you are addressing today. I can't say, speaking for the Council, that we have come to any conclusions. The views I just gave you are my own. The Council is just beginning its work and hopefully it will be timely.

Mr. LANGDON. ECAT and HP don't have defined views on this topic, but maybe a couple of observations are appropriate.

First, obviously, our current individual top rate at 28 or 33.0 percent does not provide a major incentive as a tax deduction to encourage savings. So, maybe at some point in time when that rate increases, we should look very aggressively at putting some savings devices, like a revised IRA or something like it in place. Second, as you look at where we are on a consumption-based tax, we are at total disparity with regard to our trading partners with regard to our tax system. We collect very little from any consumption based tax. I would suggest that maybe we look at what is happening in Canada.

I was in Canada a few weeks ago meeting with the Ministry of Finance people, and they spent all afternoon discussing their proposals for a national sales tax. What they are doing first is sitting down with the people in the provinces and working an accommodation so that they end up with the same method or tax base for both provincial and dominion sales tax, doing that confidentially. And they have the same scenario that we do, which is that every province except Manitoba has a sales tax in place.

The next part of the scenario will be—if they can agree upon a logical tax base—then, in effect, the provinces, and in our case the States, will collect the national sales tax. So, in effect, you don't have duplication of administration, with the exception of Manitoba where maybe the national revenue people will come in. And I think if we follow how that debate works out in Canada, we may have a role model in the U.S. with regard to how to implement a consumption-based tax here.

Also, Canada is not that different from the U.S. from a political and geographic standpoint. We may learn some other lessons from them as well.

Senator BAUCUS. Thank you. Mr. Huard?

Mr. HUARD. I think we would tend to agree with Tom Peters' observation that, if you put incentives in the Code, the taxpayers will tend to respond to them. I think we need to look at restoring some of the incentives that used to be in the Code and/or coming up with new and better ones, if you will, because I don't think for cultural or other reasons that taxpayers are likely to save very much without those incentives. I never fully understood the argument that what was wrong with IRAs was that people were just transferring savings from other accounts. When they put IRAs in, I put the maximum amount in over a year; and I couldn't transfer it from other accounts because I didn't have a nickel's worth of savings. I was spending it all.

I know that is anecdotal, but an awful lot of my friends are in the same boat. And I keep wondering where all this transfer from other accounts came from because most of the people I knew had never saved a dime before in their life.

Senator BAUCUS. I agree with that, frankly. [Laughter.]

Mr. HUARD. But it may be that we may need to look at an incremental approach where it is only increased savings that gets some kind of incentive. I think the old system of IRAs may have had some defects and could be improved on.

Senator BAUCUS. Mr. Langdon, did I hear you anticipate higher rates?

Mr. LANGDON. I just know what I read in the newspapers.

Senator BAUCUS. Do you agree with Tom Peters that wealthier folks are getting away with too much?

Mr. LANGDON. I thought he made a very interesting, cogent comment with regard to that issue. I think the stock market crash forced us to look more adroitly at our twin deficits—the trade deficit and the fiscal deficit. And I think that we need to frankly bite the bullet and make some hard choices to get both of those deficits under control.

I would hope that at some point in time Congress will begin to effectively address those issues because I think that there is the beginning of a groundswell of support among the populace that we need to deal with these problems.

Senator BAUCUS. Let me ask a similar related question. Since you are involved in tax policy to some degree, you might have a view on this. When Congress passed the 1986 Tax Reform Act, there were a lot of folks that said we made a deal, that is, we are going to lower the rates and broaden the base. In order to pay for the revenue loss, we lowered the rates and broadened the base and repealed some deductions and closed some loopholes, et cetera.

It would be wrong now for Congress to "break faith" with the American people and, say, delay the reduction of corporate and individual rates without restoring some of the deductions and exclusions, loopholes, et cetera. Do you think that it would be breaking faith with the American people if, in order to reduce the budget deficit—which is so important—even with commensurate spending cuts, if Congress raised revenue by delaying reduction of rates in way? Would that be breaking faith with the American people?

Mr. LANGDON. I think the process that the economic summit conference is going through is a very important process, which is putting everything on the table and negotiating it. I think though that the going-in preamble, which was okay for the time being—we are not going to deal with rates with regard to this current deficit reduction exercise—is an appropriate course of action. As we move one to two years down the road, I think everything is going to have to be placed on the table and should be in order to handle the dual deficit problems.

I think we have got bigger issues to deal with than the going-in assumptions that we had with the 1986 Tax Reform.

Senator BAUCUS. I appreciate that. I agree with that. I for a long time have advocated a total freeze on spending, say for a year. And several years ago when I ran for reelection, that was a cornerstone of my campaign back in my home State of Montana. I was telling everyone that, in order to get control of this deficit, we would have to freeze spending on everything. That would mean entitlements and everything—across the board for a year; and I was frankly very heartened with the response that I got, even at the senior citizen centers. I would go to a senior citizen center, and an elderly lady would look at me quizzically; and she said: You are not going to freeze my COLA, my cost of living increase? I said, well, nobody else will get an increase either. And she said: You mean, nobody else gets an increase? And I said that was right.

She said: Well, if they are not going to get their increase, I guess maybe I can go along with it, too. Now, I am convinced that the American people are fair and they will do what has to be done, so long as others are doing what they have to do. I frankly think that means everything has to be on the table, as you said.

To be honest with you, I am a little bit perplexed—and that is putting it mildly—as to why the budget summiteers haven't moved forward more quickly to take an across-the-board shared approach. I think we are caught too much inside the beltway, inside baseball, inside the committee jurisdiction, and not enough concerned with folks outside of Washington, D.C. and what they are saying.

They can do it in a fair and even-handed way, but just get the job done, because the greater interests of the country have to be considered. I don't know if they are going to do that, but I guess we will find out in the next few days.

I want to thank you very much for coming today. I appreciate your testimony. Thank you.

Our final panel consists of Mr. Thomas Horst, who is Director of Deloitte, Haskins and Sells, testifying on behalf of the Coalition of Service Industries; and Mr. William Easton, Vice President and Manager of the Trade Finance Division of the First Bank of Minneapolis, testifying on behalf of the Bankers Association for Foreign Trade.

Mr. Horst, welcome. Why don't you begin?

STATEMENT OF THOMAS O. HORST, DIRECTOR, DELOITTE, HASKINS & SELLS, WASHINGTON, DC, TESTIFYING ON BEHALF OF THE COALITION OF SERVICE INDUSTRIES, ACCOMPANIED BY WILLIAM CLINE, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. **Horst**. Thank you, Mr. Chairman. I have a written statement which I will submit for the record, and I will summarize it here. My name is Thomas Horst. I am Director of Foreign International Tax Analysis at the international accounting firm of Deloitte, Haskins and Sells. I am appearing here today with Bill Cline of the Institute for International Economics. The two of us are appearing on behalf of the Coalition of Service Industries.

The Coalition is a group of 26 large multinational service companies. Mr. Cline and myself were commissioned by the Coalition to undertake a study of the impact of the Tax Reform Act of 1986 on the international competitiveness of service companies and to compare the U.S. tax treatment of service industries with the tax treatment in eleven other foreign countries.

My responsibility was for the tax analysis section of the study. Mr. Cline undertook the economic consequences that flowed from my tax analysis. Our results are still preliminary, but I would like to share with you what I believe our central findings will be. In a nutshell, we looked at five industries, and we found that three of the service industries were really quite frankly clobbered by the 1986 Act. Those industries were banking, insurance, and shipping.

The reasons why those three industries were clobbered are twofold. First of all, the change in the Subpart F taxation rules which subject U.S. corporations to tax on income earned through foreign subsidiaries. There were three significant changes there as they apply to the international operations of service industries. First of all, the interest, dividends, etcetera, of foreign banking, insurance, and other financial service companies were subject to current U.S. tax, rather than having the tax deferred until the income was remitted.

The second change in the Subpart F area was the extension of current taxation to third country insurance premium income. So if a foreign insurance subsidiary earns premium income from any person outside that country, that premium income is also subject to current U.S. tax.

The third key change there was the repeal of the prior law exemption for shipping profits when reinvested in shipping assets. So, now all shipping profits are subject to current U.S. tax, whether or not they are brought back to the United States, and whether or not they are reinvested in shipping assets.

The second major area where the 1986 Act changed U.S. law was in the area of the foreign tax credit limitation. There, in a nutshell, there were two changes. We introduced a number of separate baskets, or separate foreign tax credit limitation categories. From the service industry perspective, probably the key changes were the separate category for what was called high withholding tax interest, but it is basically all withholding tax interest.

And then, further, for dividends received from minority joint ventures. If a U.S. shareholder has a 50 percent or less interest in a foreign subsidiary, the dividends that come from that subsidiary are subject to a separate foreign tax computation. The other area there—the other change there—was the allocation of interest expense against foreign source income. That certainly had an across-the-board effect.

Taken together, these changes—as I indicated—had a very adverse impact on three service industries. As I mentioned at the outset, we also sought to compare the U.S. tax rules before and after the 1986 Act with the tax treatment in eleven other countries. In a nutshell, those eleven countries were Japan, the United Kingdom, Germany, The Netherlands, Belgium, France, Sweden, Denmark, Switzerland, Canada, and Hong Kong. I just read them to indicate that we tried to have very broad coverage in this aspect of the study.

What we found in short was that, while a number of these other countries have provisions that are comparable to our Subpart F provisions, none of those eleven countries extended to the categories of income that were reached by the U.S. 1986 Act. So, basically, we are doing something in that area that no other country is doing right now.

Similarly, in the foreign tax credit limitation area, I think that there if you look superficially at other countries' rules, it would appear that they have some fairly tight foreign tax credit limitation rules; but what I found particularly interesting was that, when we surveyed the overseas offices of Deloitte, Haskins and Sells as to how the foreign rules were applied, in every case we were told that our foreign competitors can generally claim a full foreign tax credit for any foreign taxes that they pay.

This foreign tax credit limitation is not a major concern of the foreign competitors. It is certainly a very major concern of U.S. companies after the 1986 Act.

With that, I would like to turn briefly to Bill Cline, who will describe the economic consequences that we believe flow from the 1986 Act changes.

Mr. CLINE. Thank you. Mr. Chairman, I should first state that while I am appearing here as having participated in this study, and I am here today in a personal capacity, not representing the Institute for International Economics where I am a Senior Fellow.

The policy context of this issue, it seems to me, is one in which we have had policy created on two different tracks. We have had a tax track and a financial/economic track.

What strikes me is that, with a massive problem of external debt and large external trade deficits, we seem to have wound up with changes in the tax laws last year which significantly reduced our ability to compete abroad, at least in the sectors that we have examined.

Now, some of these have to do with closing down on foreign subsidiary activity, making that somewhat more difficult. I think one of the important things to recognize in the service industry is that, in many cases, these service firms which have followed their multinational clients abroad and have begun, in addition, to sell to foreign markets would not really be able to reverse that activity to a U.S. based operation. For example, in insurance there will be local regulations that say a firm simply has to be physically present. So, in some of these tax changes which affected foreign affiliates, it might have been thought that, after all, these firms can simply come back home.

That is not really an option; the option alternatively is simply to lose those foreign sales which, after all, are an important part of how we are going to service the external debt in the future.

One of the things that struck me in doing this study is the importance of services in our external accounts. Now, the U.S. Trade Representative's office recognizes this, but I am not sure that the tax policy and the public policy generally does to the extent that it warrants.

The services exports are an area of comparative advantage. In 1984, service exports amounted to almost $80 billion, and there was a trade surplus of $14 billion in services at a time when we had a large trade deficit in merchandise.

Similarly, our earnings of foreign affiliates in the services was something like $90 billion, exceeding the foreign affiliates' earnings in the United States by some $20 billion.

One of the things that struck me in doing this study is the number of jobs that are involved in U.S. services exports. I calculated the number of jobs per $1,000 of sales based on U.S. data and estimated that there are 870,000 U.S. workers who are involved in service sector exports; and that number is almost 60 percent as the number of direct jobs involved in manufactured exports.

Senator Baucus. Could you give me those figures again?

Mr. Cline. Right. There are 870,000 U.S. jobs involved in service sector exports and that these are 60 percent as large as the number of direct jobs involved in manufactured exports. In sum, what this says is that U.S. trade officials have been on the right track, that services are very important.

The problem, of course, that we are focusing on here is that, in the understandable and urgent need to come up with a balanced tax approach, there have been some probably unintended adverse effects on another critical policy area, which is our ability to compete abroad.

And in particular, based on the estimates of the increased tax burden that Mr. Horst prepared and looking at how much U.S. firms would have to increase their prices in order to offset those higher costs, I calculated—or tried to calculate the impact of the bill on U.S. exports of service sectors that we examined, as well as on the earnings of their foreign affiliates, based on fairly accepted methods in this area—the use of so-called trade elasticities and applying high intermediate and low ranges to what we know institutionally about each of these sectors, how price responsive the market is.

These estimates concluded that, for the five sectors we examined, the 1986 Act will reduce service sector exports by $2.6 billion annually and, in addition, reduce the earnings of foreign affiliates of U.S. service companies by $2.1 billion annually. The export figures, of course, have implications for U.S. employment. In particular, the export losses could be expected to reduce U.S. employment by some 22,000 direct jobs, the bulk of this occurring in the banking sector, somewhere in the range of 18,000 jobs, and in shipping, somewhere in the range of 4,000 to 5,000 jobs.

Now, it is important to recognize that this burden comes on top of some already difficult competitive problems. In the banking sector, the U.S. share of assets among the 500 largest banks internationally has declined from 42 percent in 1970 to 18 percent in 1985, with the mirror image reflected by a rising Japanese share. In the shipping industry, similarly, there is very severe international competition, much of it on a virtually tax-free regime.

The thrust then of this analysis, it seems to me, is to suggest the need for a reevaluation of some of these tax changes, with an eye toward making it possible for U.S. service firms to compete effectively internationally and to make their contribution to the massive job ahead of us of dealing with our large and growing external debt and our large trade deficit.

Senator BAUCUS. Thank you, Mr. Cline. Mr. Easton?

[The prepared statement of Mr. Horst appears in the Appendix:]

STATEMENT OF WILLIAM R. EASTON, VICE PRESIDENT AND MANAGER, TRADE FINANCE DIVISION, FIRST BANK OF MINNEAPOLIS, MINNEAPOLIS, MN, TESTIFYING ON BEHALF OF THE BANKERS ASSOCIATION FOR FOREIGN TRADE

Mr. EASTON. Good morning, Mr. Chairman. My name is William Easton. I am pleased to appear before this subcommittee today on behalf of the Bankers Association for Foreign Trade, (BAFT). I am a member of BAFT's Trade Finance Committee, and I am also a Vice President and Manager of the U.S. Trade Finance Group at the First Bank of Minneapolis.

As you know, BAFT is a Washington-based trade association dedicated to promoting international trade and finance. Our members include money center, regional and smaller U.S. banking institutions. Since we have submitted a formal statement for the record of these hearings, I will keep my remarks brief to allow time for your questions.

My purpose in speaking to you today is to urge you to modify a provision in the Tax Reform Act of 1986 which negatively impacts the ability of all U.S. banks to provide competitive export financing and, more importantly, which hinders the ability of U.S. exporters to be competitive in the global marketplace.

From an international competitiveness standpoint, a major concern of BAFT's U.S. bank members is the treatment of foreign tax credits which are generated by our export financing loans. Fifty foreign countries impose foreign withholding taxes on interest paid to U.S. lenders. In the trade finance context, these withholding taxes are imposed on the gross interest income paid to U.S. banks on their foreign loans to finance the importation of goods into the foreign borrower's country.

When a U.S. bank makes a cross-border export financing loan to a buyer in a withholding tax country, that bank is responsible for the withholding taxes on interest income it earns on that loan.

As you know, competitive export financing can be the key element in a successful export sale. Intense foreign competition often requires a U.S. exporter to arrange financing to support its sale. U.S. banks have traditionally provided the majority of loans which support these U.S. exports. However, the export financing exception—Internal Revenue Code, Section 904(d)(2)—has actually discouraged U.S. banks from pursuing export financing because it has reduced the profitability of this activity.

Specifically, the law reduces the ability of U.S. banks to apply the entire amount of foreign tax credits generated by an export financing transaction against their overall U.S. tax liability. This decreases the after-tax profitability on these loans. These regulations have worked against U.S. exporters, particularly small and middle market exporters by making it impossible for U.S. banks to provide export financing on terms as competitive as those offered by banks in many of our major competitor exporting countries.

The tax laws of these countries, such as Japan, England, and France, provide deductibility of foreign withholding tax on terms basically similar to those available to U.S. banks prior to the change in the tax law last year.

Under the present U.S. tax law, we as U.S. banks are faced with three alternatives. We can increase the gross spread on our export loans to a much higher level in an effort to utilize the tax credit—the entire amount of the tax credit—to be regenerating. We can have our customers, the U.S. exporters, subsidize us by increasing the cost of the merchandise or by decreasing their own profit margin; or, finally, we can abandon or deemphasize export financing.

Obviously, none of these alternatives enhances the competitiveness of U.S. exporters. More unfortunately, the last alternative is the one many U.S. banks are presently pursuing. During this summer, BAFT conducted an informal survey of the major U.S. banks responsible historically for financing most U.S. exports. We were informed by this survey that the overwhelming majority of U.S. banks had severely curtailed their emphasis on export financing.

Some banks have reduced their emphasis by 50 to 100 percent. Of all the banks surveyed, only two or three indicated they were still providing export financing based on historic levels of activity, and only one U.S. bank admitted that it had actively increased its export financing and trade financing activity.

Now, I can't explain why my competitors have done this, but I can speak for my own institution; and I can say categorically that one of the reasons why we have curtailed and refocused our trade financing activity was due to the tax law change last year, which curtailed our own profitability and made it impossible for us to continue on a profitable basis.

Many have thought that foreign banks would fill the void created by the exodus of U.S. banks from providing export financing. We, however, do not believe that is or will be the case. Foreign banks, even those which have a large U.S. branch network, simply do not have the resources to develop this business. The vast majority of trade finance transactions supported by foreign banks are for U.S. export sales made by Fortune 500 companies. Most foreign banks simply do not call on the small to middle market companies which are most in need of this type of financing assistance.

The net result is that the small and middle market exporter will not be able to locate a bank to finance its export sales. Accordingly, these companies have been placed at a long-term competitive disadvantage in the global marketplace if they need export financing.

Ironically, these are the same size companies which Dr. Peters earlier referred to as being the most competitive companies in the American economy—maybe our hope for the future, and would discourage them from exporting.

Finally, the assumption that the tax legislation you are advocating would reduce tax revenues and further exacerbate the budget deficit is, we believe, incorrect.

If U.S. banks continue to be unable to finance U.S. exports, there will be fewer U.S. exports and less U.S. production, fewer U.S. jobs and less overall tax revenue.

Conversely, the change requested by BAFT, which is outlined in our statement for the record, would, we believe, boost exports, raise production, create new jobs, and increase tax revenue. In conclusion, at a time in our history when we are all concerned about our trade and budget deficits, any measure Congress can take to encourage new exports will have a very constructive effect on reducing both the trade and the budget deficits.

We urge you to encourage U.S. banks to return to export financing by expanding the trade finance exception in the Tax Reform Act of 1986 to include all U.S. banking institutions. This will have a positive, long-term implication for all U.S. exporters, particularly those which we classify as small and middle market and for our overall trade deficit.

Thank you very much for allowing me to testify before the subcommittee today. I will be delighted to answer any questions you may have.

Senator BAUCUS. Thank you, Mr. Easton.

[The prepared statement of Mr. Easton appears in the Appendix.]

Senator BAUCUS. I think a lot of smaller firms and mid-sized firms in America are having a very difficult time exporting because so many institutions in the hinterlands of America—in the heartland—don't have the expertise, in many instances, and also because of the tax consequences. They are having a hard time finding the export financing in order to finance sales overseas.

We all tend to fall back on anecdotal evidence, but I know of one small firm, for example, in Montana that was trying to ship honey to The Netherlands several years ago. And just for the life of them, they were trying to figure out some way to finance the sale, and found that there were no local institutions that could help them with it. That was the biggest stumbling block, and the sale fell through basically because of the inability of the firm to get export financing.

I know that (a) it is a big problem and (b) it is going to be a bigger problem among the local institutions if American banks are unable to get some relief from the cost of exporting overseas. You are right, too, in trying to focus on the difference between a dynamic and a static analysis here.

Unfortunately, the Joint Tax Committee staff estimates that the provision they are advocating, and I agree with, will cost about $400 million. I guess that involves the age-old question between a static and a dynamic analysis, that is, this cost right now and not look at how much revenue is going to come in because of dynamic interplay of market forces. Unfortunately, we haven't developed the kind of computer capacity yet to sufficiently analyze dynamic analysis, and we should be looking at that more in this country. Both the Treasury should and the Congress should because it is more accurate; maybe it will be possible with the advent of the new super computers.

There is a new book out called New Theory in Chaos; it is some new theory in physics. There is nothing more chaotic than trying to determine this interplay; but you are right, we should focus on that.

Could you explain why you think the revenue loss is so much lower, because that will help here?

Mr. **Easton**. Yes, this is a very, very elusive figure, Senator. There is no central repository in the United States which can show what revenue loss has occurred from banks financing U.S. export sales. What you have to look at from an economic analysis are five factors: the volume of U.S. exports; whether those exports were made to withholding tax countries and, if so, what the rates were in those withholding tax countries. Then, you have to factor in the interest rate—the gross interest rate—on the loan times the withholding tax rate; and finally, you have to come up with some estimate on what the banks' own tax rate was.

So, when you do all of those factors, then you have to take out the Baker 33 countries because, as you know, they were given a two-year moratorium. When we had done that and we looked at these figures, we came up with a figure that was significantly below the $200 to $400 million figure that we had heard from some of the people in Treasury.

Senator **Baucus**. Actually, they go higher. They go above $400 million.

Mr. **Easton**. We were going to submit our calculations for the record, and we pulled those calculations out a week ago Wednesday. The reason for it is we came up with our preliminary figures a week ago Monday, and unfortunately, we wanted to check two of the base figures and make some adjustments on them. We wanted to be able to defend these figures. Two of the four people who were responsible for submitting these figures were out with the flu last week; I was one of them.

Accordingly, we would like a couple weeks to come up with our calculations.

Senator **Baucus**. We will keep the record open.

Mr. **Easton**. I will be happy to submit them.

Senator **Baucus**. Sure. The record will be open for a couple weeks, and you can submit them.

Mr. **Easton**. We are just looking at this on a pure static side. We are also going to submit figures on the dynamic side that show the multiplier effect of jobs.

Senator **Baucus**. I wonder if Mr. Horst and Mr. Cline could address a question that I think is on a lot of people's minds? That is, this 1986 Tax Act comparatively places a greater burden on American service industries, compared to what the burden was before. How does that compare with other countries that tax their service industries that operate abroad? Can you give us some evidence or a case of some other countries that tax their domestic service industries less than does America? Or do they tax theirs about the same?

Mr. **Cline**. Mr. Chairman, if I may, I would like to ask Tom Horst, who did that part of the study, to address that question.

Senator **Baucus**. Sure.

Mr. **Horst**. We surveyed the foreign tax rules for the eleven countries I cited in my testimony, and I can address what those eleven countries do. They are, of course, the home base for the overwhelming majority of our foreign competitors; and when you put in Japan, Germany, the U.K., Switzerland——

Senator **Baucus**. What do you find?

Mr. **Horst**. What we found, is that nobody else is taxing income the way we started doing it in the 1986 Act. We went very carefully through the foreign countries' provisions. They were on the surface, comparable to our Subpart F. Some countries had them; some countries didn't; but the ones that did have Subpart F-type provisions are not reaching out and taxing shipping income like we are, and they are not reaching out and taxing——

Senator **Baucus**. They may not do it the same way, but is the net effect more or less of a burden?

Mr. **Horst**. The net effect is very clearly a heavier burden on the U.S. companies compared to their foreign competitors, unequivocally.

Senator **Baucus**. Now, how does that square with all these studies that show that the total incidence of taxation in America is one of the lowest among countries in the industrialized world? When you total up local, State, and Federal taxes that Americans pay—and I think that incorporates individual as well as corporate taxes—as a percentage of the GNP and compare that with Japan, West Germany, Italy, France, and several other countries, the total incidence that Americans pay in taxes as a percent of the gross national product is lowest among all those, with the possible exception of Japan, where it is about even. If that is the case, then how is it that the 1986 Tax Act overburdened not only American manufacturing-based industries but service-based industries in being overtaxed?

Mr. **Horst**. If I could respond to that? I find those aggregate comparisons somewhat misleading. At most, they will be useful in telling you what the relationship is for a corporation's total tax to its total income. I think when you look at the question of international competitiveness, it is important to focus on what is the impact of the tax on engaging in international business because oftentimes a foreign country's tax system may produce a fairly high overall rate of tax without coming down heavily on its international operations.

I think what has happened as a result of our 1986 Act is that the U.S. tax burden came down much more heavily on the foreign activities of U.S. corporations than it had done prior to the 1986 Act and much more heavily than what you would find comparably outside of the United States.

Senator BAUCUS. So, you are saying that in some of these foreign countries, like West Germany and France, for example, that even though the total aggregate tax burden might be a little bit greater than it is in the U.S., they give comparatively more relief or tax their overseas operations less?

Mr. HORST. Yes. None of those countries tries to tax the income of a banking, insurance, or shipping subsidiary that is engaged in an active business. They all wait until that income is remitted to the home country as a dividend before they would impose a tax. We are the only country that I know of that reaches out and taxes that income when it is earned, even though it is in a bona fide business.

That is a clear distinction between our system and theirs.

Senator BAUCUS. Now, all of you sat very patiently through Tom Peters' presentation—the prior panelist. Do any of you have anything you want to say or anything that you want to get off your chest, something that has gotten under your skin a little bit, that you think would be helpful to help improve America's competitive position?

Mr. HORST. I think it is important to realize that there may not be a whole lot we can do affirmatively to promote competitiveness, but there are certainly some things that we have done in the 1986 Act that discourage companies from going out there and competing. And it may be worth having another look at those provisions.

When you get down to the real microeconomic detail, looking at how the Act is affecting specific industries, there may be some things you would want to look at.

Senator BAUCUS. Let me ask you a question that might bother you a little bit. A lot of commentators are saying that one problem with America's declining competitive position is that we have too many lawyers; we have too many accountants; we have too many finance guys. The financial officers are too important in a company; that is, we don't have enough scientists; we don't have enough engineers; we don't have enough products people.

The top graduates of the business schools go to Wall Street; they are the finance guys who put the deals together. The top graduates of the business schools don't go into production, and they don't go into engineering, and they don't go into building a better product. What about that? Do you think that maybe we in America are spending too much time rearranging the financial statements of companies and not enough time trying to build a better product?

Mr. HORST. Again, if I could comment on that? I think we have an extremely complex tax system. We, like most other tax accountants and lawyers, are looking at——

Senator BAUCUS. I can say that because I am a lawyer.

Mr. HORST. Yes. The compliance burden resulting from the 1986 Act will be staggering; it is absolutely staggering. I think what you see in terms of the number of otherwise productive people who are working in the tax field and in the accounting field and in the financial field, certainly on the tax side, I think to a significant extent that is a reflection of the type of tax system that we introduced; and if we had different kinds of rules, if we put more emphasis on compliance burdens that are going to result from tax laws, that we could shift many people, including myself, into more productive lines of employment.

I would certainly be happy to volunteer for that.

Senator BAUCUS. What about that? Do you think we should look more seriously toward some very simplified tax structures and spend less time trying to build a better tax break or trying to get around the taxes or how to comply with them? CPAs of major U.S. firms, I find interestingly in the last few days, or last several weeks, have indicated to me that perhaps we should have a gross receipts tax of some kind, and just get rid of all this stuff. So, there would be more compliance and more resources freed up to start working on developing product. I don't want to waste our time here, but should we—in your judgment-and you are a practitioner so, my gosh, you know this stuff in and out—should we be looking for a much more simplified system?

Mr. HORST. Yes, I think we should. I think we could do a whole lot more to simplify our tax system than we have done in the past. I think that is the great overlooked virtue of tax systems. I think we started off trying to have more simplicity, along with lower rates, etcetera; and in effect, the simplicity was the clear victim of the 1986 Act.

Senator BAUCUS. As you all know, simplicity and equity are often enemies.

Mr. HORST. Yes.

Senator BAUCUS. The more we try to be more fair—when someone says he is in a different situation here and is being treated unfairly, so we make an exception in that case—that just adds to the complexity. So, what you are saying is that we should sacrifice some"equity and fairness,"or perceived equity and fairness, for more simplicity in the Code. And you are saying that would help America be a bigger, stronger, more productive country; is that right?

Mr. HORST. I believe it will.

Senator BAUCUS. Do other countries have codes that are significantly more simple than ours?

Mr. HORST. A number of countries, I believe, do. I think we probably have much more of a penchant for trying to develop very elaborate statutory rules and then have the Internal Revenue Service and the Treasury Department——

Senator BAUCUS. Which countries have more simple systems that perhaps we should as a country look at?

Mr. HORST. I am not an expert on other countries' systems. I must say that, from my dealings, I am not aware of any country that has a system that is as complex as ours. I know that—and I am attempting to respond to your question—in the international area, the Canadian system may be somewhat simpler than our own, somewhat better thought through than our own. I think that that may be a relevant model to look at; but I don't know whether we need to just go out and emulate what other countries have done.

Senator BAUCUS. Yes.

Mr. HORST. I think that, if we just say let's come up with a system that doesn't have the compliance burdens that the present system does, we can do it.

Senator BAUCUS. That is tough. I have a relative who is a practitioner, and it is interesting to listen to him. Years ago, he would say to me sometimes that he doesn't sleep at nights, worrying about giving his clients his best and total advice because of all the changes in the Code and all the complexities in the Code. He is a practitioner who is involved in this problem.

All right. I want to thank you all very much for helping out. This is not the last time we are going to address this issue; but you have made significant contributions, and I want to thank you very much. I thank you particularly for pointing out the problems the services sector is facing; that is something new that I think a lot of folks really hadn't focused on before. I appreciate that very much.

Mr. HORST. Thank you, Senator.

Senator BAUCUS. Thank you. The hearing is adjourned.

[Whereupon, at 12:11 p.m., the hearing was adjourned.]

PAUL R. HUARD
VICE PRESIDENT, TAXATION AND FISCAL POLICY DEPARTMENT
NATIONAL ASSOCIATION OF MANUFACTURERS

Thank you, Mr. Chairman. I am pleased to be here this morning to present the Association's views on the interrelationship of tax policy and international competitiveness.

First, however, I must point out that NAM believes the single most important public policy step that can be taken to improve U.S. trade competitiveness is decisive action by the federal government to reduce its massive deficits through spending control and without further tax increases.

For it is spending and not taxes that have caused the problem, and it is therefore to spending that we ought to look for the solution. About three decades ago, federal taxes accounted for around 19% to 20% of GNP. They still do. What has happened in the interim is that federal spending--which also used to account for around 19% to 20% of GNP--has burgeoned to a level of about 24% of GNP. The result is a permanent structural imbalance which produces huge deficits even during periods of sustained economic growth.

As we have observed in detail in other Congressional testimony before the Joint Economic Committee and elsewhere, these chronic structural budget deficits over the current decade have contributed significantly to our trade deficit by raising (1) our real interest rates, (2) our consumption rates and (3) our cost of capital. Until quite recently, in fact, U.S. trade competitiveness has been more adversely affected by the budget deficit situation than by tax policy.

With the advent of the Tax Reform Act of 1986, however, U.S. tax policy has become a much more adverse determinant with regard to competitiveness. The principal result of these "reforms" will be a massive redistribution of income, on the order of $25 to $30 billion annually throughout the rest of the century, from corporations to individuals. An immediate result has been a 15% to 20% increase in the cost of capital for investment in manufacturing equipment. A number of the long-term effects, as illustrated in the graphs shown at Appendix A, are even more disturbing:

- By 1990 and indefinitely thereafter, tax deductions for depreciation will fail to compensate for actual economic depreciation.
- By 1990 business fixed investment as a share of GNP will fall to a 25-year low.
- By 1990 the share of GNP devoted to personal consumption will rise to its highest level since 1950.

-- Corporate cash flow will decline steadily and before the end of the century will hit a 40-year low.

It should be obvious from the foregoing that, in order to get the increased savings and investment needed to improve productivity and competitiveness, we must act to reverse the extreme bias of the "reformed" federal tax code against savings and investment and in favor of consumption. In the short run, however, it is even more important that we not further exacerbate the existing state of affairs, which is bad enough as it is.

What I mean by this is that Congress should reject the tax increase legislation recently developed in each of the Congressional tax-writing committees. These bills have proven admirably suited for political posturing, enabling the Speaker of the House and the Chairman of the Ways and Means Committee, among others, to boast proudly that their entire burden falls upon corporations and "the rich." As examples of tax policy, however, they are simply deplorable, and would serve principally to further intensify the already pronounced anti-investment bias of the existing code.

Nor are they necessary. To return to my original opening theme, it is both desirable and possible to achieve the current deficit reduction goals largely through expenditure restraint. To the maximum extent feasible, Congress should institute a "freeze" under which all discretionary program outlays are held at or near present levels for a year or two. Thereafter, whenever program growth is permitted to resume, it should not be allowed to exceed the then current growth in GNP.

Entitlement programs too should make a contribution, and with no exceptions allowed. Major savings can be attained here simply by limiting all automatic cost-of-living adjustments. It is important to note that despite all of the inflamed rhetoric usually surrounding this issue--invariably involving use of the term "benefit cut"--providing COLAs at something less than 100% of the full rate of inflation would not cause a cut in benefits for any recipient. It just means that benefits, while continuing to increase, would do so at a slower rate.

To exclude Social Security beneficiaries from even such a modest limitation would be a great mistake. It would give one class of citizens 100% protection against inflation, something no other segment of our society receives. This is grossly unfair to the many other groups--for example, wage earners, farmers, and businessmen--who get no such protection and who, as a result of this exclusion, must shoulder a disproportionate share of the deficit reduction burden.

In retrospect, putting entitlement COLAs on full automatic pilot has been one of the costliest misjudgments ever made by the Congress, having over time caused enormous growth in the expenditure base. This is part, though clearly not all, of our deficit problem and curbing it must be part of the solution. Some type of "COLA cap" on entitlements is a long overdue reform.

Should Congress desire still more than the amount of deficit reduction that can be achieved from the combination of a "COLA cap" and a discretionary program "freeze," then we strongly urge that it tap the significant revenue gain to be had from a sharp reduction in the capital gains tax rate. Both sides of this question can be, and have been, argued at length. We believe the preponderance of the economic analysis as well as the clear weight of the historical evidence favors the view that such a reduction would increase, not decrease, federal income tax revenues. Dropping the rate to 15% would restore the differential between capital gains and ordinary income to the approximate level prevailing before the 1986 changes and could, we believe, reasonably be expected to raise around $10 billion annually.

Looking ahead to the longer term, however, it seems quite unrealistic to assume that Congress will not eventually turn to major tax increases as a component of future deficit reductions. If it does so, Congress should use this as an opportunity to achieve real reform of the federal taxing system. Such reform should seek to make the system more pro-competitive by reducing its extreme tilt, already noted in the discussion above, toward consumption. NAM believes such reform could best be accomplished through implementation of a general consumption tax designed in accordance with the following principles:

1. It should apply on a transaction basis, e.g., it should be imposed on an ad valorem basis when a taxable good or service changes hands. Some indirect methods of taxing consumption, for example by providing unlimited income tax deductions for net savings and investment, are theoretically attractive. For the present, however, this line of approach is impractical due to the many definitional, transitional and political problems it would raise.

Other indirect methods, often referred to as "subtraction method" value added taxes, are subject to a variety of criticisms: (a) the ability of sellers to pass such taxes forward to ultimate consumers is suspect; (b) for compliance purposes, such taxes do not leave as good a "paper trail" as the traditional invoice and credit method of collection; and (c) it is more difficult to accurately rebate such taxes on exports.

2. It should apply at a single uniform rate to the broadest possible base of taxable goods and services, so as to spread its burden equitably across the entire economy, while at the same time permitting the tax rate to be as low as possible given the amount of revenue intended to be raised. Omission of the service sector would be particularly unfair, requiring higher rates on a much narrower base and disproportionately impacting those groups that consume more goods than services.

Multiple rates not only add undesirable complexity but also introduce economic distortions as well as being inherently unfair. For this reason, introduction of a general consumption tax system at the federal level should be accompanied by simultaneous repeal of all selectively-imposed federal excises.

3. It should apply to the full value of covered goods and services, up to and including retail value, and should be separately stated and readily identifiable at that level. Omission of the retail level results in an unnecessary narrowing of the tax base. The reason the tax should be visible at the retail level is obvious: taxpayers should know how much they are paying for the cost of government. One of the undesirable aspects of a subtraction method VAT is that it is so easily hidden from the consumer.

4. It can and must be adjusted for regressivity. There is no doubt that a general consumption tax system can be regressive. Fortunately, this can be adjusted for in a manner that is both effective and efficient, i.e., in such a way that impacted low-income consumers get the relief that is intended for them and no unintended benefits are conferred on others. This can be achieved by providing, through the income tax system, a refundable credit that is phased out above certain income levels. Because of the phase-out feature, higher income individuals not needing relief would not get any. Because the credit would be refundable, those with incomes so low as to have little or no tax liability would still get the full amount of intended relief.

The exclusion of certain items—food, for example—is a less desirable approach to mitigating regressivity. Exclusions not only erode neutrality and simplicity, they also are highly inefficient because they benefit all income levels, including those perfectly able to stand the tax burden.

5. It should not apply to exports. Taxes paid by a manufacturer are part of the cost of doing business and, under normal circumstances, are reflected in the price of the product. Many of our industrial competitors, however, finance a significant part of the costs of their government with VAT taxes, which are

rebatable on exports. The major taxes paid by U.S. manufacturers are payroll and corporate income taxes which, although they may make up part of a product's cost, are not rebatable if that product is exported. This unquestionably puts U.S.-based producers at a competitive disadvantage in export markets.

These are the rules we have agreed to play by as signatories to the General Agreement on Tariffs and Trade ("GATT"), and our trading partners are unlikely to agree to any change in such rules that would wipe out their existing advantage in this regard. We do, however, have the option of financing a greater proportion of the cost of our federal government with taxes that under present GATT rules are rebatable on exports. A general consumption tax would be just such a tax.

6. No part of the revenues from a general consumption tax should be used to finance additional spending. Simply described, our problem is that the national government takes in revenues totalling around 19% to 20% of GNP but spends at a rate of 23% to 24% of GNP. New tax revenues not used to replace other taxes should only be used to close this gap, not to further inflate an already excessive level of government outlays.

Our final recommendation is that a significant portion of the revenues derived from a general consumption tax should be used to reduce existing federal corporate income taxes. Ideally, the theoretically correct solution is outright repeal of the federal corporate income tax. If, as seems more realistic, the corporate tax is retained, there are two improvements to it that would have very pro-competitive effects:

- A more generous capital recovery system could be provided. As already noted, a major defect of the 1986 "reforms" is that the value of tax deductions for depreciation does not compensate for actual economic depreciation. Improvements in the capital recovery available to U.S.-based producers could be achieved in a number of ways, including restoration of an investment tax credit, increased acceleration of depreciation deductions, or expansion of the availability of expensing.
- The corporate and individual income tax systems could be properly integrated, so as to eliminate the double taxation of corporate earnings paid out as dividends to shareholders. Under present law, a dollar of corporate earnings paid to a shareholder can carry an income tax burden as high as 56 cents at the federal level alone. Eliminating or substantially moderating the double taxation burden would lead to a helpful reduction in the cost of corporate capital.

At first blush I suppose it might seem somewhat daring to argue that what is needed is more taxes on consumers and less taxes on corporations. As the tables in Appendix B make quite clear, however, it is a conclusion fully supported by the facts. These tables show that even before the redistribution of tax liabilities that is the hallmark of the 1986 changes, corporations were paying federal income taxes at an average effective rate more than two and one half times that of individuals. Now, with the 1986 law in effect, the average effective federal income tax rate for corporations is more than triple that for individuals.

The Appendix B tables disclose two other interesting facts. One is that the personal income base is at least twelve times as large as the corporate profits base, suggesting rather pointedly where Congress ought to look if it wants to raise large sums of additional revenue with minimum economic dislocation. An additional $37 billion in taxes on individuals would raise the average personal effective tax rate one percentage point, from 10% to 11%. A $37 billion tax increase on corporations, on the other hand, would raise their effective rate 12 percentage points, from 34% to 46%.

The second is that from FY86 to FY87 corporate profits increased by almost $70 billion, a tidy gain but for the fact that about three-fifths of this gain or $42 billion was immediately siphoned off in increased federal income taxes. That, frankly, is an awful lot of money that can't be used to acquire modern plant and equipment, or to perform research and development, or to hire additional employees.

I would like to make one final point. The allegation that corporate tax cuts are responsible for the deficit problem is demonstrably false. One version of this argument is based on the declining share of GNP accounted for by corporate income tax receipts. There is, of course, a perfectly rational explanation for the decline, which is that corporate profits likewise have declined as a share of GNP. From 1960 to 1980, for example, corporate income taxes as a share of GNP fell by nearly a third, from about 4.5% to about 3.1%. So what? Over the same period, corporate profits as a share of GNP also fell by a third, from 9.6% to 6.4%. As a result, there was not really any decline in the corporate tax burden.

The central flaw in the "share of GNP" argument is that a decline or rise in such share tells you nothing about the effective level of taxation. To determine that, income is the variable that needs to be examined. If a wage earner's gross pay dropped by a third over a period when GNP grew by 4%, who would have the colossal effrontery to suggest that such person's taxes ought to rise 4% to stay in a constant relationship to GNP?

Another popular variation is to blame the deficit situation on the "excessive" 1981 tax cuts. The only problem here is that whatever cuts corporations initially were intended to receive under the 1981 law have long since been reneged on, whereas individuals have retained virtually every penny of theirs. For example, the table in Appendix C shows that over fiscal years 1987 through 1989, individuals will pay $630 billion less in federal income taxes than if no tax legislation at all had been enacted since President's Carter's leaving office, while corporations will pay $55 billion more. Those inclined to blame the deficit situation on the 1981 cuts are certainly entitled to their opinion, but ought to follow it to its logical conclusion.

This concludes my prepared statement. I would be glad to address specific inquiries that any member of the Subcommittee might have at this time.

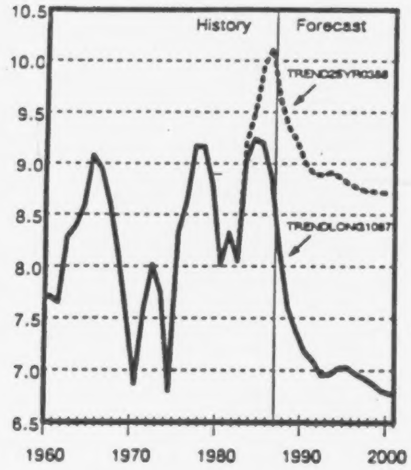
APPENDIX A

Long-Term Effects of Tax Reform

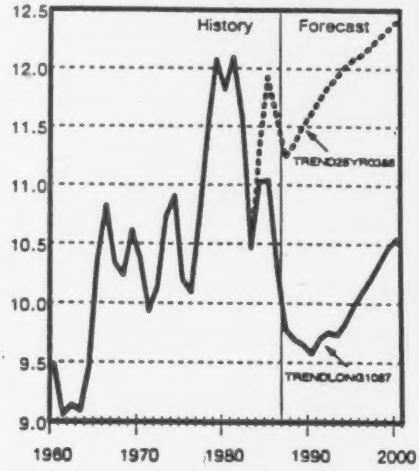
[dotted line is forecast prior to Tax Reform Act
of 1986; solid line is post-reform forecast]

Source: Data Resources

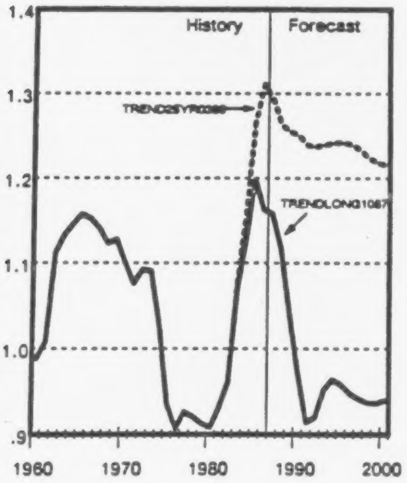
**Corporate Cash Flow
As a Percent of GNP**



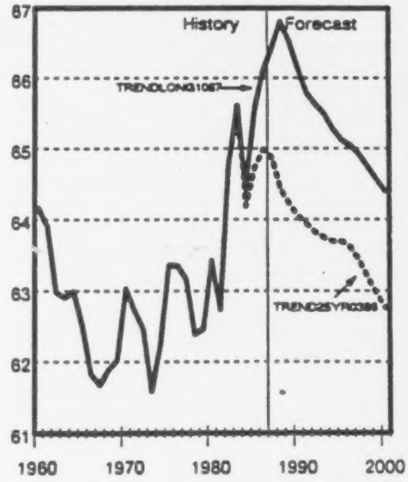
**Business Fixed Investment
As a Share of GNP
(Percent)**



**Ratio of Depreciation Allowances
to Economic Depreciation**



**Personal Consumption Expenditures
As a Share of GNP
(Percent)**



APPENDIX B

COMPARISON OF FEDERAL INCOME TAX LIABILITIES OF CORPORATIONS AND INDIVIDUALS

FISCAL YEAR 1986	Individuals	Corporations
Personal Income/Corporate Profits Before Tax	$3.5 Trillion	$240 Billion
Average Effective Tax Rate	10%	26%
Federal Income Taxes Paid	$349 Billion	$63 Billion

FISCAL YEAR 1987	Individuals	Corporations
Personal Income/Corporate Profits Before Tax	$3.7 Trillion	$309 Billion
Average Effective Tax Rate	10%	34%
Federal Income Taxes Paid	$364 Billion	$105 Billion

Increase in average effective rate for individuals. FY87 over FY86: 0%

Increase in average effective rate for corporations. FY87 over FY86: 30%

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Source: Budget of the United States Government. Fiscal Year 1988

APPENDIX C

"WE GAVE AT THE OFFICE"

WHAT U.S. CORPORATIONS HAVE TO LOOK FORWARD TO AFTER SIX YEARS OF TAX LEGISLATION UNDER THE REAGAN ADMINISTRATION

A Comparison of the Net Effect, over the Fiscal Years 1987 Through 1989, of All Income Tax Legislation Enacted Since President Carter Left Office

	Individuals FY87-FY89	Corporations FY87-FY89
Income Tax Cuts Enacted Under the Economic Recovery Tax Act of 1981	$635 Billion	$163 Billion
Net Income Tax Increases Under Tax Bills Enacted in 1982, 1983, 1984, and 1986	$5 Billion	$218 Billion
Dollar Amount of 1981 Income Tax Cuts Remaining	$630 Billion	-$55 Billion
Percentage Amount of 1981 Income Tax Cuts Taken Back	1%	133%

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Sources: Budget of the United States Government. Fiscal Year 1987; General Explanation of the Tax Reform Act of 1986. Joint Committee on Taxation Document JCS-10-87.

STATEMENT OF
LARRY R. LANGDON
DIRECTOR OF TAX AND DISTRIBUTION
HEWLETT-PACKARD COMPANY

Mr. Chairman, and members of this distinguished committee, my name is Larry R. Langdon. I am the Director of Tax and Distribution of Hewlett-Packard Company, headquartered in Palo Alto, California. I am appearing on behalf of ECAT, the Emergency Committee for American Trade.

Description of Hewlett-Packard and ECAT

Hewlett-Packard is a major designer and manufacturer of electronic products and systems for measurement and computation. During its last fiscal year, Hewlett-Packard Company and its subsidiaries had sales of $7.1 billion, about 46% of which were to customers outside of the United States. Worldwide R&D expenditures last year were $824 million, or 11.6% of sales. About 90% of HP's R&D was conducted in the United States. HP exported from the United States products with a value exceeding $1.4 billion, and is ranked by Fortune and Business Week as among the top ten or fifteen exporters, even though HP is ranked 51st in overall size on the "Fortune 500" list. Hewlett-Packard has over 82,000 employees worldwide, of whom about 53,000 work in the United States.

I am appearing before you this morning on behalf of the Emergency Committee for American Trade.

ECAT is an organization formed in 1967 to support measures which expand international trade and investment. Its members are the leaders of 60 large U.S. firms with extensive overseas business interests. They are among the largest U.S. exporters and investors in foreign markets. The sixty members of ECAT have combined annual worldwide sales in excess of $700 billion, and they employ more than five million people.

International Competitiveness

As you know, John Young, Hewlett-Packard's president and chief executive officer, chaired the President's Commission on Industrial Competitiveness. The Commission's report is one of the most thoughtful and thorough analyses of factors affecting the international competitiveness of U.S. companies.

The Commission on Industrial Competitiveness defined "competitiveness" in the following way:

> *Competitiveness is the degree to which a nation can, under free and fair market conditions, produce goods and services that meet the test of international markets while simultaneously maintaining or expanding the real income of its citizens.*

One primary conclusion of the Commission was that competitiveness is affected by a range of factors, no one of which predominates. Obviously the strength or weakness of the dollar, the size of the federal budget deficit, inflation rates, monetary policy, trade laws, tax policies, and many other factors all have an impact on our competitiveness. Thus, improving our international competitiveness will require action on a broad range of issues, not just one or two. Certainly the trade legislation now being considered by the Congress is of critical importance, as are efforts to reduce the federal budget deficit.

Impact of Tax Laws on Competitiveness

U.S. tax policies undoubtedly influence our international competitiveness. I thank you for the opportunity to discuss some of the particular aspects of the U.S. tax laws that impact our competitiveness in both positive and negative ways.

Rate Reduction

ECAT endorses wholeheartedly the significant cut in corporate income tax rates by the Tax Reform Act of 1986. I would like to stress that every effort should be made to preserve these low rates. Low tax rates clearly help our competitive position.

It is important to remember, however, that the Tax Reform Act imposed a major tax increase on corporations through base broadening and elimination of major incentives for investment. Future tax legislation should provide a balanced treatment between individuals and corporations, since additional after-tax income for corporations generally finances investment while additional after-tax income for individuals tends to finance consumption.

Incentives and Disincentives for Technological Innovation

R&D is the lifeblood of high-technology companies in the electronics industry. However, R&D is critical to such industries as pharmaceuticals, aerospace, defense, and to many others. Technological advances are applied by other industries and services, such as automobiles, banking, and telecommunications, thus having great effects on the productivity of many sectors of the economy.

The speed of technical change and the need for significant R&D expenditures to keep pace with this change are illustrated by a characteristic of HP's sales. Year after year, over half of HP's total worldwide revenues are from products released within the current and two previous years. Producing new products at such a rapid pace demands a large R&D effort, and federal tax policies should encourage the R&D necessary to enable U.S. companies to compete in high technology markets.

Extending the R&D credit through 1988 was a positive development and ECAT encourages the Congress to make the R&D credit a permanent feature of U.S. law. The additional resources which could be channeled to R&D efforts over a period of years with a permanent R&D credit in place clearly would add to our ability to compete.

The Tax Reform Act rules place equipment used in R&D in the five-year category under the modified ACRS depreciation rules. Moving such equipment to the three-year category would be appropriate as a further inducement to utilize the most modern equipment in conducting R&D.

The R&D allocation rules under section 861-8 of the Income tax regulations create a tremendous disincentive for U.S. companies with foreign operations to conduct R&D in the United States. These rules are complex, but in essence they disallow a tax deduction for a portion of a company's R&D conducted in the United States. Therefore, the current regulations create an incentive for a company to move its R&D activities outside of the United States. Mr. Chairman, you and Senator Wallop have been leading proponents of legislation to repeal the 861-8 R&D regulations, and have played key roles in developing a compromise that is supported by the Administration, the Treasury Department, industry, and members of the Finance Committee and Ways and Means Committee. ECAT and Hewlett-Packard Company greatly appreciate your efforts in this area. A permanent resolution of this issue is needed. We hope the compromise which is included in both the House and Senate bills currently under consideration will be adopted this year so that the significant disincentive for conducting R&D in the United States caused by the 861-8 regulations would be substantially reduced.

Drs. Martin N. Baily and Robert Z. Lawrence, both Associate Fellows of the Brookings Institution in Washington, D.C., completed a study earlier this year entitled "Tax Policies for Innovation and Competitiveness." Their study concluded that the "case for government programs to stimulate commercial R&D rests on sound analytical grounds," because society tends to underinvest in commercial R&D. Their study also concludes that aggregate R&D spending in the United States is 7% higher than would have been expected without the credit, leading to a GNP in 1986 that was $8 billion to $13 billion higher than it would have been. The study cautions against imposing regulations which raise the costs of performing R&D in the United States.

Having a tax code that promotes the conduct of R&D in the United States is critical to the long-term economic health of the United States economy. R&D has spillover effects on the whole economy. It is also key to providing a high standard of living for the American people. It is harder for the United States to compete in certain world markets in which low-cost labor is an important factor. If we lower wages here to compete, our standard of living will fall. With technological leadership, however, we can create additional jobs and a higher standard of living.

The U.S. has been a technological leader in the past. U.S. tax laws should provide permanent, favorable rules which provide positive incentives for conducting R&D in the United States, so that this leadership will be maintained in the future, as well.

Another important consideration is that manufacturing jobs most often are created near the location where R&D is conducted. Thus, by encouraging R&D, we will promote manufacturing as well.

Our competitors around the world have recognized the importance of R&D incentives in their tax systems. For example, Australia recently provided for a 150% tax deduction for R&D expenses. Japan has had a 20% R&D tax credit in place since 1966. The U.K. permits a current year tax deduction for machinery, equipment and buildings used for R&D. Canada has three special provisions to encourage R&D: (i) a 150% deduction for current R&D, (ii) a 150% deduction of capital expenditures on R&D undertaken in Canada, and (iii) an investment tax credit (which is generally 10%) for both current and capital expenditures.

A decade or more ago, HP, like most U.S. companies, almost automatically located important R&D facilities in the United States for non-tax reasons. But more recently, the opportunities for locating facilities abroad have increased substantially. Decisions on locating R&D facilities are now subject to much closer scrutiny. In this environment, tax considerations, including major disincentives such as the Section 861-8 R&Dregulations and the lack of a permanent R&D tax credit play a role in company decisions.

In 1980, an internal study conducted by HP concluded that it would be economically advantageous on an after-tax basis to increase the portion of our worldwide R&D effort conducted outside the United States. Instead, partly because of the moratorium on R&D allocations under Section 861-8 and the R&D tax credit were enacted, we have increased our domestic R&D expense from $327 million in 1981 to $739 million in 1986. If these two legislative provisions which favor the conduct of R&D in the United States are not made permanent or extended, the analysis might again favor the location of R&D offshore. In fact, this result could be more compelling now than in 1981 because of favorable R&D incentives enacted since 1981 in other countries and the foreign tax credit rule changes in the United States.

Exports

The U.S. tax laws have for over 60 years had a provision that treats part of the profit on exports as foreign source income, sometimes called the "title-passage" or "export source" rule. This rule is only of benefit to exporters with substantial foreign tax liabilities, either directly or indirectly through foreign subsidiaries. The export source rule was actively debated during tax reform and was, practically speaking, preserved for companies that export products from the United States, including such exporters as Hewlett-Packard Company and most other ECAT member companies.

The Conference Report directed Treasury to conduct a study of the source rule, which has not yet been completed. However, a study recently completed by Gary Hufbauer, Wallenberg Professor of Economics at Georgetown University, and Arthur Hammond-Tooke concluded that repeal of the export source rule would lead to a reduction of exports of between $3.9 and $5.4 billion and would lead to a loss of jobs in the United States of between 115,000 and 160,000. These are very serious consequences. ECAT urges Congress to retain this provision of critical importance to exporters.

Mr. Chairman, we also want to acknowledge the role you and Senator Chafee have played in sponsoring a bill to have the study of the source rule conducted by the Department of Commerce and Special Trade Representative, as co-authors with the Department of Treasury, to be sure that trade and competitiveness factors are taken fully into account in the study, to avoid a focus on technical tax policy issues.

The impact of repealing the source rule will be to increase taxes on exports, by an amount that will vary from company to company. For most companies, however, the marginal tax rate on exports will increase substantially. Thus, if this provision of the tax law that currently encourages companies to manufacture in the United States and to export is eliminated or curtailed, companies will find that the relative tax costs of manufacturing outside the United States rather than in the United States will be reduced, thus creating an additional reason to increase manufacturing outside the United States.

One other important provision of U.S. tax law which encourages exports, the Foreign Sales Company ("FSC") rules, clearly should be retained.

Export Financing

As you know, the 1986 Tax Reform Act provides for a very limited exception to these burdensome new foreign tax rules for certain types of export financing. Congress did so in express recognition of the potential anti-competitive impact the changes might have on U.S. export trade. It is my understanding, Mr. Chairman, that you and Senator Roth are sponsoring legislation to significantly broaden this exception to cover all export financing activities. I commend you for this initiative and hope that Congress can act on the proposal this year.

If we are to begin closing the trade deficit, we must expand U.S. exports. It is difficult enough to compete against the aggressive export promotion policies of our foreign competitors. We cannot afford to lose sales due to the unavailability of adequate financing on competitive terms. Moreover, we must not overlook the fact that for every one billion dollars in exports, between 20,000 and 25,000 new American jobs are created.

Capital Formation

The Tax Reform Act of 1986 enhanced the ability to earn and improve corporate profits by reducing the corporate tax rate.

The changes to the depreciation rules, while a reasonable compromise, certainly provide lower incentives for capital investment than the depreciation regimes of many of our major trading partners, particularly after the elimination of the U.S. investment tax credit.

International Provisions of the Code -- Deferral, Double Taxation

The provisions of the Internal Revenue Code that deal with the taxation of the international activities of U.S. companies have for years been governed by two general principles -- first, the deferral of taxation on income of foreign subsidiaries, with exceptions for tax haven activities (Subpart F), and, second, the use of an overall foreign tax credit to avoid international double taxation.

The provisions of the Tax Reform Act of 1986 in these two areas are of great concern with regard to our international competitive position.

The United States not tax the income of foreign corporations until returned to the United States. This is commonly referred to as "deferral." Subpart F embodies certain exceptions to deferral. The underlying theory of Subpart F is that income earned in passive transactions between related parties is potentially abusive. Active, unrelated party transactions are subject to deferral and they should be -- that is, real businesses conducting real international operations should not be taxed currently on funds they have not received.

ECAT historically has been opposed to the elimination of deferral.

The concept of deferral was severely eroded by the Tax Reform Act of 1986, which reduced the Subpart F threshhold from 10% of gross income to the lower of 5% of gross income or $1 million. Many of Hewlett-Packard's foreign manufacturing and sales operational subsidiaries have historically maintained cash balances that will generate more than enough interest income to exceed these minimum amounts, without any tax avoidance motive whatsoever. Under the new rules, there will be current U.S. taxation of this income. Furthermore, the purpose of the de minimis rule, to avoid added complexity where there is no significant tax avoidance purpose, will be frustrated since any income exceeding the new threshhold will be treated as a current dividend for U.S. tax purposes, even if there is not an actual distribution of profits.

The passive foreign investment company ("PFIC") rules adopted by the Tax Reform Act of 1986 also severely curtail the deferral concept. The PFIC rules, which apply to controlled foreign corporations ("CFC's") already subject to Subpart F, would essentially end deferral on operating income for CFC's making the Qualified Electing Fund election. The mechanics of the PFIC rules are fairly complicated, but making CFC's subject to the PFIC rules was a fundamental attack on the concept of deferral that should be reversed.

Our principal foreign competitors do not tax the earnings of their foreign subsidiaries nearly as aggressively as the United States taxes foreign subsidiaries of U.S. companies. Some countries, such as France and the Netherlands, generally exempt foreign source income from taxation altogether. Others utilize the overall limitation or other measures which achieve the same result. For example, Japan taxes foreign source income but foreign tax credits are computed under an overall limitation with "tax sparing" treaties with many countries. Tax sparing treaties permit foreign tax credits to be claimed in Japan even though no foreign taxes were paid. Germany (by treaty) and Italy (by dividend exemption) also allow for significant exemption of foreign source income. Belgium exempts most foreign source income, and any foreign source income subject to tax can be offset by foreign tax credits computed under an overall limitation. Even in the United Kingdom and Canada where per country limitations are employed, averaging of high and low foreign tax rates still can be legitimately achieved.

The Tax Reform Act of 1986 also causes major concern about the avoidance of international double taxation. The many new "baskets" established for purposes of computing the foreign tax credit limitation will result in a major erosion of the overall foreign tax credit limitation concept and create much greater likelihood that U.S. based companies will be subject to international double taxation. Complexity in U.S. taxation for foreign subsidiaries will grow geometrically.

The basket approach artificially divides the foreign income of a worldwide business, with the objective of increasing U.S. taxes on foreign income, not to protect U.S. taxation of domestic income. For example, establishing both a passive basket and a high-tax basket prevents identical categories of income from being averaged together, which seems designed only to increase U.S. taxation of foreign income.

The separate basket approach has been justified by stating that calculating foreign tax credits based on the overall, or average, foreign taxes paid is an abuse. This sentiment was unanimously opposed when offered in justification for the per country proposal.

Income From Imported Property ("Runaway Plants")

In the current effort to raise taxes, one provision which the House Ways and Means Committee has adopted, but which the Finance Committee has not, would end deferral on "profits on imported property." More specifically, this provision would tax currently in the United States income earned by foreign subsidiaries on manufactured products that are used or consumed in the United States. Also, these earnings and any other income, such as royalties and interest attributed to such earnings would be subject to a separate foreign tax credit limitation.

ECAT and Hewlett-Packard Company are both emphatically opposed to such a provision.

We are opposed because it places U.S. based companies at a significant competitive disadvantage; it virtually repeals deferral, a fundamental principle of U.S. tax rules; and it may have unintended consequences because it reflects a total misapprehension of the global nature of international economic competition.

The House Budget Committee report acknowledges that this tax would apply to imports from U.S.-controlled foreign subsidiaries, but would not apply to Japanese or European-controlled subsidiaries and other foreign corporations. Hewlett-Packard, has a foreign subsidiary which owns a factory in Malaysia down the street from a factory owned by a Japanese company. Under the House provision, Hewlett-Packard would be subject to current U.S. tax at a 34% rate on profits from products sold to the U.S. market, while the Japanese company would not be subject to any tax. Furthermore, because of a tax sparing treaty between Japan and Malaysia, the Japanese company could repatriate profits back to Japan free of any tax, while under current rules, Hewlett-Packard would be subject to U.S. tax on such dividends. The Japanese company would have the advantage of either greater after-tax profits to invest, or the ability to retain profit margins while lowering prices to obtain U.S. market share.

The erosion of such a long-standing principle of U.S. tax law is philosophically wrong. To abandon this principle without debate of the issues because it may be a politically viable way of raising revenue is most inappropriate when the proposed repeal will affect so profoundly the multinational sector of the U.S. economy, which is the source of the vast majority of U.S. exports. Also, there has been no demonstration that U.S. companies are systematically shifting manufacturing jobs outside the United States to avoid U.S. taxes to such a degree that the current rules that help Hewlett-Packard and other ECAT members to compete internationally should be rewritten to our detriment in the hopes of counteracting some activities that comprise a tiny portion of the real economic activity of America's major international companies.

As I indicated earlier, Hewlett-Packard is a net exporter from the United States by a wide margin. Yet, in an effort to be competitive internationally, we generally manufacture in one factory for the worldwide marketplace, whenever possible. (Exceptions to this approach may exist for certain of our products which have high volumes, and in certain countries, particularly in Latin America, where we need a manufacturing presence in order to sell anything at all in the local marketplace.) Furthermore, in other industries there is frequently no choice whatsoever about foreign locations, when raw materials or other special factors are present in the foreign location.

In this context, the House provision could set up tax consequences which could make it advisable for Hewlett-Packard to shift a greater percentage of our manufacturing out of the United States than we would shift back into the United States in order to avoid the impact of this rule. This might occur because the full gamut of actual and proposed changes to the U.S. tax rules that apply to our international transactions may make it more desirable for Hewlett-Packard over time to balance imports and exports on a country-by-country, particularly in the current international trade climate. U.S. tax rules which cut down on our flexibility and incentives to export from the United States could lead to this more balanced result, which would be contrary to the result we presume the proposed policy changes of recent years seek to achieve. Furthermore, the additional U.S. tax costs of this rule, which no foreign competitor would be required to match, might in the future force U.S. companies to manufacture in two places products that are today manufacturer in only one place. The duplication of costs involved in such a situation would increase the price of our products, clearly making them less competitive.

Let me emphasize that I have been discussing possibilities. What will actually happen in the short term will be affected more by current investments in plant and equipment, as well as obligations to our employees in both the United States and foreign locations, than by the marginal impact of U.S. tax laws. In the longer term, however, this proposal, if enacted, could prove counterproductive at best.

GATT Treatment of U.S. Tax System

ECAT is also concerned with the issue raised regularly by Congress relative to the trade effects resulting from different GATT treatment of direct taxes, such as income taxes, compared with indirect taxes, such as sales or value-added taxes. The latter may, under GATT, be rebated on exports and added to imports, but no such so-called border adjustments are allowed by GATT on direct taxes. The U.S. relies far more on direct than indirect taxes compared with many other countries, and is thus, in the view of many analysts, disadvantaged in trade by the difference in GATT treatment. Section 121 of the Trade Act of 1974, as amended, called for "the revision of GATT articles with respect to the treatment of border adjustments for internal taxes to redress the disadvantage to countries relying primarily on direct rather than indirect taxes for revenue needs," and this is repeated again in Section 105(b)(2)[M] of the Senate version of this year's trade bill as a principal objective of international trade negotiations.

Conclusion

Obviously, I have touched upon only a few of the many issues this Subcommittee will consider in its examination of tax policy and U.S. international competitiveness. In closing, however, I wish to reiterate my view that tax policy can and should play a legitimate role in fostering a more productive and competitive economy. The specific proposals I have mentioned regarding Section 861 and export financing are prime examples and warrant favorable Congressional consideration. That concludes my comments. I would be pleased to respond to any questions.

TESTIMONY OF DR. HARVEY BALE, JR.
INTERNATIONAL PUBLIC POLICY MANAGER
HEWLETT PACKARD COMPANY

Thank you Mr. Chairman. I am pleased to be here today to discuss the issue of fiscal policy and the deterioration of America's competitive position. I am representing the Council on Competitiveness, a private sector organization composed of chief executives of the corporate, labor, and academic communities. The Council is chaired by the President and Chief Executive Officer of Hewlett-Packard Company, Mr. John Young.

At the outset, I would note how timely these hearings are. With the recent gyrations in the stock market, there has been a renewed commitment on the part of both Congress and the Executive Branch to develop a credible deficit reduction package. All issues -- spending and tax -- appear to be on the table. In the short-term, it is essential that the markets be assured that the political process in the United States is working. This will require agreement on a multi-year deficit reduction package which exceeds the spending cuts mandated under Gramm-Rudman-Hollings.

Today all eyes are focused on the budget summit. The challenge will be to ensure that attention remains focused on the budget deficit, particularly as it relates to our declining competitiveness. This is where these hearings are particularly important. I hope that the findings of this hearing -- which explore the competitiveness implications of various fiscal policy mechanisms -- will find their way into future deliberations on deficit reduction.

This morning, I would like to highlight for you the Council's activities in the area of fiscal policy. The Council has determined that a top priority should be to explore the issue of fiscal policy and its implications for our competitive position in the world economy. Council interest grew out of a belief that while significant consensus exists on the necessity of credible deficit reduction, there is little agreement on the appropriate mix of fiscal policy tools -- both spending and tax -- to achieve deficit reduction. The issue is further complicated by the fact that in developing a package, consideration must be given to both the short-term economic implications of spending cuts and revenue increases, particularly as the U.S. and world economies slow down, and to efforts to restore U.S. competitiveness.

We envision that the Council's work could be useful in two respects. The first is to help build a broad-based consensus for the difficult political choices necessary to achieve sustained credible budget deficit reduction. The second is to help ensure that in crafting the tax and spending components of U.S. fiscal policy that restoring our competitiveness becomes a major policy objective. In previous deliberations on both tax and spending, little consideration appears to have been given to the implications for our competitive position.

The Council has established a senior-level task force to explore the issue of what constitutes a pro-competitive fiscal policy. Our first task is to define, in an understandable way, the linkages between the U.S. budget deficit and declining competitiveness, specifically as it relates to the trade deficits and declining productivity. A clear understanding of the linkages is necessary to help build the consensus for some potentially difficult choices in the areas of spending and tax. I would like to spend a few minutes this morning discussing these linkages.

Mr. Chairman, the existence of large and protracted Federal budget deficits in a low saving society has contributed to two of the clearest indicators of our declining competitiveness -- the large trade deficits we have run since 1981 and decreased levels of investment which contribute to declining productivity.

The United States has historically had a lower private savings rate than its major industrial trading partners. During the period from 1973 to 1985, U.S. gross saving averaged approximately 19 percent of our gross domestic product (GDP). Comparable figures for our major trading partners range from 18 percent in the United Kingdom to 33 percent in Japan. In the 1980s our savings rate fell even further -- averaging 17 percent between 1981 and 1986. As a nation we just do not save enough for both domestic investment needs and a large budget deficit.

The role of the Federal budget deficit on saving and investment flows is dramatic. There is a significant gap between what we as a nation save and what we invest. The key factor in the equation is the Federal budget deficit, which serves to reduce the amount of saving available for domestic investment.

To date, the saving shortfall in the United States has been made up by foreign capital inflows. These inflows have allowed us to consume more than we produce. But this practice is not without serious costs to the economy.

The most significant problem is that the enlarging net inflows of foreign capital are the mirror image of growing current account deficits. These deficits -- which were in the $150 billion range in 1986 -- have arisen through interest rate and exchange rate adjustments that have been driven, in part, by Federal budget deficits.

As important from a competitiveness perspective as the effect of the budget deficit on trade deficits, is its affect on investment in the United States. The budget deficit, in conjunction with low private saving, has increased the cost of capital available for business investment.

The level of domestic investment becomes more important when compared to investment levels of our major trading partners. Between 1973 and 1985, we devoted 13.8 percent of our GDP to investment. All of our trading partners devoted considerably more with Japan topping the list at 24.2 percent of GDP. Interestingly, these same countries experience considerably higher productivity growth rates than the United States during a comparable period. To increase our productivity, investment levels in the United States should be considerably increased.

The implications of the trade deficits and lower levels of investment, both of which can be related to the budget deficit, can be summed up as follows.

- First, the accumulation of several years of current account and merchandise trade deficits has transformed the United States from the world's largest international creditor to a net international debtor with foreign debt of about $264 billion at the end of 1986. If as estimated, U.S. debt held abroad reaches $800 billion within 5 or 6 years, servicing that debt will cost more than $50 billion per year. Until we run trade surpluses of that magnitude, the foreign debt will continue to accumulate.

- Second, large merchandise trade deficits affect overall economic growth levels and have caused serious dislocation in certain sectors of the economy, particularly manufacturing.

- Third, U.S. economic policy-making -- both fiscal and monetary -- is constrained by our need to attract foreign capital to finance the saving-investment gap. At the same time, we have become increasingly vulnerable to changes in the economic policies of foreign countries and in investor perceptions of the economy.

Aside from the implications related to our increased dependence upon foreign capital inflows, there are other competitiveness problems associated with running large and protracted budget deficits.

- Budget deficits limit our ability to respond in the event of a serious recession. With Federal budget deficits in the range of $150 to $200 billion, we are somewhat constrained in using fiscal measures to stimulate the economy.

- Finally, budget deficits, by competing for a smaller pool of private saving, prevent the United States from undertaking the type of investment necessary to increase productivity and stimulate new product development.

The preceding illustrates quite clearly the role of the Federal budget deficit in America's declining competitiveness. Our next step -- which will be the core of the project -- is to explore various combination of spending tools to determine which best meet our goals of reducing the deficit and enhancing American competitiveness.

We plan to look first at the spending side of the ledger -- both in terms of where additional spending cuts could be made without harming our competitiveness and where additional funding may be necessary to support our competitiveness objectives. We are proceeding from the notion that spending cuts are possible -- recognizing the difficulty of the task -- and that some reprioritization of spending may be inevitable. Interest payments, which constitute a growing portion of the budget deficit, cannot be touched. After a rapid rise in the early eighties, defense spending has declined in real terms over the past two years. Discretionary spending -- which includes funding for a number of the most important competitiveness programs -- is down to 1960 levels. And the entitlement programs, which constitute the lion's share of the Federal budget, pose their own set of political problems.

On the tax side, we are being guided by the assumption that the principal goal of any tax increases we are considering is deficit reduction. Two approaches to taxes are being explored. The first is what could be called a "piecemeal approach." This involves looking at a variety of changes to the current tax system, including excise taxes, the gasoline tax, among others. We will also be exploring major revisions to the tax code, including a consumption tax. We will be analyzing these tax proposals against a set of criteria which includes: effectiveness as a budget deficit mechanism; impact on economic growth; affect on saving and investment; controllability; and fairness.

This project represents a significant undertaking for the Council. In attempting to develop a pro-competitive fiscal policy, we will face many of the same pressures that you in the public policy arena face. We hope that we can capitalize on and help encourage further development of the mandate from the markets and the American public to significantly reduce the Federal budget deficit.

Mr. Chairman, it is clear that credible deficit reduction must be a top national priority -- both today and in the future. Yet deficit reduction, without attention to our competitiveness objectives, could over the longer-term prove to be as harmful as helpful. Attention must continue to be focused on this important, but often overlooked, reality. These hearings are a useful step in that process. We hope that the work of the Council will also contribute to this important policy debate.

Thank you.

Testimony of Thomas Horst
On Behalf of the Coalition of Service Industries, Inc.

Mr. Chairman and Members of the Subcommittee, I am Thomas Horst, a Director at the international accounting firm of Deloitte, Haskins and Sells. I am pleased to appear before you today to address the effect of tax reform on the international competitiveness of U.S. businesses. With William Cline, I am here on behalf of the Coalition of Service Industries, for which we have conducted a study on this issue.

The Coalition is a group of 26 of America's largest multinational service companies. The objectives of the group have included liberalization of trade in services, improvement of the nation's statistical base on the service economy, and more equitable tax treatment for service industries. In conjunction with this latter goal, Mr. Cline and I have conducted a study on the effect of the Tax Reform Act of 1986 on the competitiveness of five selected service sectors, and used that information to calculate the effect on the U.S. balance of payments and employment.

Our findings at this point are preliminary, but we can give the Subcommittee an overall sense of what we have determined.

I conducted the first part of this study, which quantifies the impact of the 1986 Act on the amount several service industries, including ocean shipping, commercial banking, and insurance, would have to charge foreign customers in order to derive the same after-tax profit as those companies would have earned under prior U.S. tax law.

These quantitative estimates reflect not only the 1986 changes in the tax treatment of foreign income per se, but also the generally applicable tax rate reduction and base broadening provisions, including the repeal of the bad-debt reserve deduction for large banks, the discounting of loss reserves of property and casualty insurance companies, the decelleration in tax depreciation, the repeal of the investment credit and the Alternative Minimum Tax. The analysis concludes that the 1986 Act had a significant adverse competitive impact on:

Cross-border lending, including loans to finance U.S. exports, subject to foreign gross withholding taxes;

Interest and other investment income earned by foreign banking, insurance and other financial service subsidiaries subject to low foreign effective tax rates;

Premiums and other income received by foreign subsidiaries for insuring U.S. or third-country risks;

Shipping income, whether earned directly by a U.S. corporation or through a foreign subsidiary.

These categories of service income earned by U.S.-based companies were competitively disadvantaged not only by comparison to pre-1986 U.S. tax law, but also by comparison to comparable income earned by foreign-based service companies under their particular foreign tax systems.

An examination of specific service sectors provides useful examples.

Ocean Shipping

It is generally acknowledged that a healthy U.S. Merchant Marine industry is essential for: (1) U.S. defense interests; and (2) the commercial interests of the United States.

Approximately 78 percent of the U.S. ocean liner commerce moves in vessels owned by foreign nationals and operated under foreign flags. This dominance results from favorable competitive factors available in the foreign owner's country of residence and vessel registry. Among the favorable factors are tax incentives, direct subsidies and beneficial tax regimes.

The Tax Reform Act of 1986 has further disadvantaged the competitive activity of U.S.-owned shipping companies by:

A. Extending the depreciable life of U.S.-flag vessels from five to ten years and repealing the 10 percent Investment Credit;

B. Repealing the (Subpart F) deferral of U.S. tax previously available to U.S. owners of foreign corporations which reinvested their income in qualified shipping assets.

C. Reducing the limit on the amount of foreign income taxes which are creditable against U.S. income tax by sourcing income derived from transportation between the U.S. and foreign countries as only 50 percent foreign. Under prior law, virtually all of this income was foreign source.

D. Further limiting the foreign tax credit mechanism for transportation income by requiring that a separate foreign tax credit limitation be used and by reducing that limitation by any foreign losses of a non-shipping nature.

E. Enacting the Alternative Minimum Tax which, for a capital intensive industry like shipping, creates an additional burden on cash flow.

No other country has adopted measures making the conduct of a shipping business by their own nationals substantially more expensive.

Commercial Banking

The Tax Reform Act of 1986 made significant and far-reaching changes in the taxation of U.S. banks, their foreign loans, and their foreign subsidiaries. These tax changes, coupled with a highly restrictive regulatory environment, have made U.S. banks increasingly less competitive with foreign banks. The salient factors which have contributed to making U.S. banks less competitive are discussed below.

The 1986 Act repealed the tax deductible bad debt reserve of larger commercial banks, i.e. individual banks and smaller banks in holding companies with assets in excess of $500 million. Although these U.S. banks may take tax deductions for bad debt losses on a specific charge-off method, they may not reserve against loan losses under an "experience method" reserve. In contrast, most foreign countries with which the U.S. competes permit their commercial banks to use a bad debt reserve.

The 1986 Act also lessened the ability of U.S. banks to compete with foreign banks due to the new foreign tax credit "separate basket" for cross-border loans subject to high gross withholding taxes. The new U.S. rule is unique among international tax systems. This rule subjects to a separate foreign tax credit limitation the interst earned by U.S. banks on cross-border loans to foreign borrowers which are subject to foreign government gross withholding taxes in excess of five percent. The effect is that the U.S. banks can no longer "average" high and low foreign tax liabilities -- thus reducing the profitability of foreign lending, particularly loans to

LDC's and emerging nations, to the point that such loans are no longer economically viable.

It is noteworthy that of the 11 countries whose tax systems were examined in this study, the United States has been notably unsuccessful in negotiating tax treaties with foreign countries, particularly emerging nations and LDC's, to reduce foreign gross withholding taxes. In the case of LDC's, the U.S. has negotiated only two treaties reducing foreign withholding taxes, whereas France, Germany and Italy, for example, have negotiated tax treaties which reduce withholding taxes with between four and six LDCs. Seven of our trading partners have negotiated treaties with Brazil which reduce the 25 percent Brazilian withholding tax to 15 percent (and in the case of Japan, 12.5 percent), whereas the U.S. has not negotiated any treaty to reduce the Brazilian tax. However, the U.S. tax authorities and Congress have sought to deny the creditability of the Brazilian withholding taxes to U.S. banks which make loans to Brazilian borrowers (including loans to finance the importation of U.S. goods).

A by-product of the new high withholding tax basket for interest on cross-border loans is that the 1986 Act prohibits U.S. banks from using the "export financing interest exception" which would otherwise remove U.S. bank lending to finance U.S. exports from this limitation. The effect is that U.S. banks have virtually stopped making any new cross-border loans, including loans to finance foreign borrowers who purchase U.S. merchandise exports.

The 1986 Act also changes the Subpart F Rules applicable to banks by making the income of foreign banking and related banking activity of foreign subsidiaries of U.S. banks subject to U.S. taxation on a current basis. Previously such foreign subsidiaries' income was not subject to U.S. taxation until the income was dividended-up to the U.S. parent. This is another factor which has made U.S. banks less competitive with foreign banks -under country systems which either permit some type of deferral for foreign subsidiary income or exclude such income from taxation altogether (e.g., France).

In general, the new U.S. tax environment as above described, coupled with the U.S. regulatory environment, has caused a decline in the ability of U.S. banks to maintain their historical levels of competitiveness with foreign banks. In addition to tax considerations, this is due, the banking industry believes, to a number of regulatory factors such as the continuation of restrictions on U.S. banking powers under the Glass-Steagall Act and the geographic limitations imposed on U.S. banks under the McFadden Act. Further, a number of important foreign jurisdictions impose certain restraints on the ability of U.S. banks to operate abroad, e.g. U.S. banks are required to operate in certain countries through foreign subsidiaries rather than foreign branches or are not permitted to engage in certain types of activities which their banking competitors in the host countries are allowed to perform.

Insurance

Our survey of the insurance sector turned up several other problems unique to the industry. We found that U.S.-based multinational insurance organizations generally face two kinds of competition.

A. Foreign-owned (non-U.S. based) multinational insurers compete for global accounts (i.e. the worldwide coverage of risks; both U.S. and foreign, purchased by large multinational firms based in the U.S. and elsewhere).

B. Foreign-owned local insurers challenge the ability of U.S. insurers to enter and expand their presence in the already fiercely competitive local markets.

Neither foreign-owned multinationals nor foreign-owned local insurers bear the burden of the complicated and aggressive U.S. tax system. Similarly, neither must face the additional burdens that result from the Tax Reform Act of 1986. There are three substantive differences between the U.S. tax system applied to controlled foreign corporations and the foreign country rules under which non-U.S. insurers operate.

First, the U.S. tax burden on controlled foreign corporations is greater than that of foreign jurisdictions, even if the foreign tax rate is equal to or higher than the U.S. statutory tax rate. This paradox is one result of the Tax Reform Act of 1986 which substantially broadened the U.S. tax base.

Second, the U.S. is the only industrialized nation that taxes currently the worldwide income of not only the resident parent but also of its non-resident controlled foreign insurance corporations. Other nations, to the extent they tax affiliates' insurance income at all (and many do not), do so only upon repatriation.

Third, the U.S. foreign tax credit provides only partial relief from double taxation, unlike virtually all foreign jurisdictions that tax worldwide rather than territorial income. Although these jurisdictions avoid double taxation through roughly the equivalent of the U.S. foreign tax credit (and each has a nominal limitation similar to ours), universal experience outside the U.S. is that the full benefit of such credit is available. This discrepancy was great enough under the old U.S. tax law, and will be worse under the Tax Reform Act.

The additional burden borne only by U.S. multinational insurers must yield one or more of the following results:

A. A premium increase (by only U.S.-owned foreign incorporated insurers) of at least 7 percent would be necessary in order to achieve the same profitability. Because of uniformity of products, local regulatory constraints and, moreover, fierce competition, such a price acceleration would be unacceptable in the marketplace.

B. Severe cost containment could preserve the same profitability. However, such a course would impact adversely upon the quality and, thereby, the competitiveness of the service offered.

C. Profit expectations could be lowered. However, many U.S. multinational insurers necessarily will conclude that continued, much less, expanded international insurance activity is unattractive. Even those retaining their current level of business will experience greatly reduced profits, thus depriving them of the reinvestment resources necessary for expansion.

The inability to offer foreign coverage at competitive prices must lead to the loss of U.S. business as well, becuase multinational insurance buyers will place their global business with foreign-owned multinational insurers.

Of course, the obvious results of such an anticompetitive disadvantage will affect adversely the U.S. Treasury, because taxable income from international operations necessarily will shrink substantially.

Further, while U.S. insurers will not only continue but will be encouraged by the new Subpart F Rules to place reinsurance with foriegn reinsurers not subject to U.S. income tax (particularly through the London market), U.S. insurers themselves will no longer be able to compete for reinsurance of foreign risks. As a result, the U.S. balance of payments will be affected unfavorably.

Conclusion

The Tax Reform Act of 1986 made far-reaching changes in the U.S. tax system. These changes have disadvantaged most U.S. service sectors operating in foreign markets. This is critical given our trade position and the importance of maintaining our competitive edge abroad. My colleague, William Cline, will speak to the broader effects of the tax changes.

Thank you.

WILLIAM R. EASTON
ON BEHALF OF
THE BANKERS' ASSOCIATION FOR FOREIGN TRADE

The Bankers' Association for Foreign Trade (BAFT), which has been in existence since 1921, is a trade association of money-center, regional, and smaller banks dedicated to promoting international trade and finance. Its U.S. voting membership includes virtually all U.S. banks actively engaged in international banking and trade finance. BAFT is pleased to have an opportunity to present its views to the Subcommittee on the crucial issue of the Internal Revenue Code's impact on U.S. trade finance.

From an international competitiveness standpoint, one of the greatest concerns of BAFT's U.S. members is the treatment of tax credits earned by U.S. banks for gross withholding taxes (those in excess of 5 percent) which they pay to foreign governments. In the trade finance context, these withholding taxes are imposed on gross interest income paid to U.S. banks on loans to foreign borrowers which finance the importation of U.S. goods and commodities.

BAFT's members have spent the year since the 1986 Tax Reform Act (TRA '86) became law analyzing the impact that the new foreign tax credit separate limitation for high withholding taxes is having upon the ability of U.S. banks to finance the exports of U.S. businesses. BAFT has concluded that the TRA '86 has indeed had a negative impact on trade finance, and therefore respectfully recommends a change in the 1986 Tax Reform Act.

Specifically, BAFT urges an amendment to IRC Section 904 (d)(2), which creates an exception for export financing interest in the case of the separate foreign tax credit limitation for interest subject to high withholding taxes.

THE SCOPE AND IMPORTANCE OF TRADE FINANCING

Financing is a critical competitive component in nearly every export sale. Intense foreign competition requires U.S. exporters to quote an "all-in" price to foreign buyers of U.S. goods and commodities that includes financing costs. U.S. exporters have therefore turned to their U.S. bank lenders to provide this crucial financing component and to assume the associated foreign buyer credit risk. Money-center, regional, and smaller banks, however, have been discouraged from attempting to meet this need for competitive trade financing because of several factors, including the damaging effect which the 1986 Tax Reform Act has had upon the treatment of U.S. bank cross-border lending income. This in turn has hurt U.S. prospects for increased trade and has exacerbated the U.S. trade deficit; the result has been lost business opportunities and lost profits for U.S. exports, and lost jobs for American workers.

The foreign tax credit limitation rules of the 1986 Tax Reform Act have worked against U.S. exporters by making it impossible for them to provide export financing on terms as competitive as those offered by banks of other major industrial countries. The tax laws of countries such as Germany, Japan, France and the United Kingdom continue to provide deductibility of foreign withholding taxes on such transactions on terms generally similar to those available to U.S. banks prior to the changes made by the 1986 Tax Reform Act.

In a sample survey, BAFT found that a decline in the trade financing activities of U.S. banks had commenced at the same time that new restrictions on the use of foreign tax credits by U.S. banks were being adopted in the House Ways and Means Committee in the fall of 1985 as a part of tax reform. Although U.S. banks financed approximately $6 billion worth of U.S. exports in 1986, the interest from which was subject to high withholding taxes, that figure represented a reduction of between 50 to 100 percent from 1985 levels. That dramatic decline has continued in 1987.

The problem of U.S. banks in connection with financing U.S. exports has been highlighted in the financial press in the last six months. Lengthy newspaper reports have focused on the reduction in the ability and willingness of U.S. banks to finance exports for a number of reasons --- including the reduced ability to claim the foreign tax credit on trade finance loans due to the high withholding tax limitation. As it impacts trade finance, the key problem with the separate limitation for high withholding taxes is that virtually all of the countries to which U.S. companies export impose such taxes.

ADVERSE IMPACT OF FOREIGN TAX CREDIT CHANGES ON EXPORTS

U.S. banks are no longer able to offer competitive financing in support of U.S. exporters because of the separate limitation on interest subject to high withholding taxes. The competition from foreign exporters and their lenders will not allow U.S. banks to pass the additional costs along to foreign buyers.

In an example attached hereto, the loss of the full use of foreign tax credits earned on a typical trade finance transaction involving the purchase of a $5 million machine results in an increase of over 175 basis points in the interest rate on the financing. Just as the price of that machine must be competitive when the same or similar goods are offered by other prospective sellers, the cost of the financing associated with that sale must also be competitive. (2 other examples attached)

Because the nations which are our principal foreign trade competitors do not impose similar limitations on the use of tax credits earned by their banks, American banks alone are faced with the choice of offering uncompetitively expensive financing packages, absorbing additional costs which make export financing unprofitable, or abandoning export financing altogether. Unfortunately for our nation's trade competitiveness, the latter has been the only realistic option for too many U.S. banks.

Fifty foreign countries impose foreign gross withholding taxes for interest paid to U.S. lenders. The U.S. also imposes such a tax at a 30 percent rate, unless the rate has been reduced by an income tax treaty. (The U.S. Treasury has been notably unsuccessful negotiating tax treaties with developing nations, which buy more than one-third of U.S. exports.) When a U.S. bank makes a cross-border loan to a buyer in a withholding tax country to purchase goods, the bank becomes liable for the withholding tax on the interest income earned on the loan.

Under the U.S. tax law prior to the TRA '86, U.S. banks were able to take a full foreign tax credit for gross withholding taxes paid abroad on interest they received. While taxation systems differ among countries, the pre-TRA '86 foreign tax credit for withholding taxes was comparable to the current treatment of such taxes by our major export competitor countries.

Under the TRA '86 if a foreign withholding tax on interest exceeds 5 percent, the interest income and tax credits are subject to the special high withholding tax limitation. (On average, foreign withholding taxes range from 10 to 30 percent.) These credits cannot be used to the extent they exceed the U.S. rate of tax on net income. These disallowed credits thus substantially increase the costs of cross-border lending by U.S.

banks to high withholding tax country borrowers. These additional costs must be absorbed by the U.S. bank or paid by the borrower in the form of higher financing costs.

EXPORT FINANCING INTEREST EXCEPTION

When the 1986 tax bill Conference Committee considered the new separate limitation for interest subject to high withholding taxes, it recognized that a financing problem might be created for U.S. exporters. In response to this concern, it created an exception for export financing interest income. Unfortunately, this exception is drafted so that only manufacturers, growers, processors, or a related party (e.g., a captive finance subsidiary) may obtain the benefit fo the exception. U.S. banks are ineligible to receive the preferred treatment granted by the exception because they are barred by federal law from being manufacturers, processors, etc., or "related to" such entities. As a result, and key to BAFT's concerns, this provision has been of virtually no use to U.S. exporters. Although some large U.S. manufacturers have finance subsidiaries which are able to make trade financing deals for their parent companies, the vast majority of U.S. businesses still must look to U.S. banks to provide trade finance. It is this problem which is addressed by BAFT's proposal. It would enable unrelated parties, such as U.S. banks, to receive export financing interest and treat it as financial services income for foreign tax credit purposes. While the problem created by the separate limitation for high withholding tax interest still remain for the majority of cross-border loans made by U.S. banks, this particular and important problem for U.S. exporters would be cured by this legislation.

Finally, the assumption made by some that adoption of this legislation would reduce tax revenues and further exacerbate the budget deficit is incorrect. If U.S. banks continue to be unable to finance U.S. exports, there will be fewer U.S. exports, less U.S. production, fewer U.S. jobs, and less overall tax revenue. Conversely, enactment of BAFT's proposal would boost exports, raise production, create new jobs, and increase tax revenues.

CONCLUSION

The trade financing problem created for U.S. exporters and their bankers by the TRA '86 foreign tax credit rules would be corrected by adoption of the BAFT proposal. Trade financing is critical to the growth of U.S. export, which in turn is vital to increased U.S. production and jobs. Allowing U.S. banks to get back into the trade finance business is thus crucial to our national economic trade interest.

The change being proposed is endorsed by the U.S. Chamber of Commerce, the National Association of Manufacturers and the National Foreign Trade Council.

1986 Tax Reform Act - Foreign Tax Provisions
Exclusion of U.S. Banks from Export Financing
Example: $5.0 million U.S. Manufactured Product

	Old Law		New Law			
			Competitive Rate of 8.0%		Pre 86 TRA Profit Rate of 9.75%	
Income						
Cash interest	$300,000		$300,000		$368,000	
W/H Tax Receipts	100,000		100,000		121,000	
	400,000	(1)	400,000		489,000	(2)
Expense						
Interest (1)	(375,000)		(375,000)		(375,000)	
	(5,000)		(5,000)		(5,000)	
	(380,000)		(380,000)		(380,000)	
Income before taxes	20,000		20,000		109,000	
Income Tax Expense						
Foreign Tax	(100,000)		(100,000)		(121,000)	
U.S. Taxes before tax credit (3)	(7,000)		(7,000)		(37,000)	
Foreign Tax Credit	100,000	(4)	32,300	(5)	62,000	(5)
Total Taxes	(7,000)		(74,700)		(96,000)	
Income (loss) after taxes	$13,000		(54,700)		$13,000	

Assumptions and Notes

(1) Terms: 5.0 million loan at gross interest of 8.00 percent for 1 year; Brazilian withholding tax withheld at 25 percent on gross interest; cost of funds is 7.50 percent.

(2) Rate must be increased from 8.00 to 9.75 percent to maintain pre 86 TRA profit.

(3) Tax Rate - 34 percent

(4) Under pre 1987 tax rules, the U.S. tax on all of the Bank's foreign source net income exceeded foreign taxes paid on such income. Thus the $100,000 of foreign taxes was fully creditable against the U.S. tax.

(5) Maximum allowable foreign tax credit:

	A	B
Gross Income	$400,000	$489,000
Expenses per U.S. tax rules	305,000	305,000
Net foreign income - U.S.	$95,000	$184,000
U.S. tax at 34 percent	$32,300	$62,000
Maximum foreign tax credit	$32,300	$62,000

EQUIVALENT YIELD COMPUTATIONS FOR FOREIGN LOANS
5/4/87

ASSUMPTIONS:

Interest Rate on Loan	9.00%
Cost of Funds Rate	7.50%
Principle Amount of Loan	1,000,000

	Old Law 46%	New law 34%	Repriced under New Law
Gross Yield	90,000	90,000	94,358
Cost of Funds	(75,000)	(75,000)	(75,000)
Pre-Tax Earnings	15,000	15,000	19,358
Federal Income Tax	(6,900)	(5,100)	(6,852)
Foreign Tax Withheld	(9,000)	(9,000)	(9,436)
Net Income Before FTC	(900)	900	3,340
Foreign Tax Credit	9,000	4,760	4,760
Net Income After Tax	8,100	5,660	8,100

The foreign tax credit limitation will be equal to the U.S. tax liability of the separate basket which requires a special allocation of all expenses.

We estimate the effect of the new foreign tax credit limitation as follows:

Foreign Tax Credit Limitation Under New Law:

$$\frac{\text{Australian loan}}{\text{Consolidated Bank Assets - Tax Exempt Assets}} \times \text{Consol. Bank Interest Expense} = 57{,}000$$

+

Allocated Non-interest Expense = 19,000

Total Allocation of All Expenses 76,000

Foreign Tax Credit Limitation
(90,000 - 76,000) x 34% 4,760

1987 Tax Reform Act (TRA) - Foreign Tax Provisions
Financing Export Trade
One Specific Loan Financing the Export of Coal

Terms

Loan of $3,546,029 at gross interest rate of 9.39% (libor floating) for a term of 181 days. Brazilian income tax withheld of 25% on gross interest. 1988 U.S. income tax rate of 34%. Cost to fund floats with libor (6.4%).

Financial Statement Profitability Impact

	Old Law Competitive Rate of 8%	New Law Competitive Rate of 8%	Pre 86 TRA profit Rate of 12.30%
Gross interest income	$166,400	$166,400	$218,081
Expense Incurred (Excluding Income Tax)			
Interest expense	(113,657)	(113,657)	(113,657)
All other (including overhead)	(16,843)	(16,843)	(16,843)
Pretax net income	35,900	35,900	87,581
Income Tax Expense			
Foreign income tax expense	(41,600)	(41,600)	(54,520)
U.S. Income Tax Expense:			
o Before foreign tax credit (34% of $35,900)	(12,206)	(12,206)	(29,777)
o Foreign Tax Credit	** 41,600	2,829	20,400
Net Income (Loss) after taxes	$23,694	$15,077	$23,684

** Calculation of U.S. Credit for Foreign Income Tax Payments

Gross Income	[NOTE	$166,400	$218,081
Expenses "determined under tax rules"	A]	(158,080)	158,080)
Foreign income taxable in U.S.A.		8,320	60,001
U.S. tax @ 34%		2,829	20,400
Maximum foreign tax credit	$41,600	2,829	20,400

NOTE A: Under pre 1987 tax rules, the precredit U.S. tax on all net income earned abroad exceeded foreign taxes paid on such income. Thus, the $41,600 foreign taxes on the above transaction would be fully creditable toward the U.S. tax liability. Also, under pre 1987 tax rules, expenses attributable to the $166,400 of foreign sourced income would be $129,800 Due to new methods to allocate and apportion expenses, the "attributable" expenses are approximated at $158,080.

STATEMENT OF ERNEST J. CORRADO, PRESIDENT AMERICAN INSTITUTE OF MERCHANT SHIPPING

The American Institute of Merchant Shipping (AIMS) is a national trade association representing 23 U.S.-flag shipping companies which own or operate approximately eight million deadweight tons of tankers, dry bulk carriers and other oceangoing vessels engaged in the domestic and international trades of the United States. This statement is in response to the Senate Finance Subcommittee's on Taxation and Debt Management hearings on the effect of tax laws on American competitiveness.

The tax policy of the United States, and in particular the Tax Reform Act of 1986, severely effects the competitiveness of the U.S.-flag maritime industry. Ocean shipping is a capital intensive industry. Tax burdens on the U.S. maritime industry contribute to our difficulty in competing with foreign flag carriers that generally face few, if any, taxes on ocean shipping. Furthermore, tax burdens on domestic carriers makes shipping more expensive and reduces the ability of our domestic carriers to compete with alternative modes of transportation.

Congress recognized in the Merchant Marine Act of 1920 that a U.S.-flag merchant marine is necessary for national defense, and foreign and domestic commerce of the United States. Today, the U.S.-flag fleet is probably in its most depressed state ever. Most authorities believe that the current fleet is not adequate for our national security requirements. To maintain a U.S.-flag merchant fleet, it must be competitive. We believe that the tax policy of the United States should foster that competitiveness rather than hinder it. Generally, U.S.-flag vessels in international commerce must compete against foreign owned vessels under the flags of countries which provide tax incentives and beneficial tax regimes, or do not tax their merchant shipping fleets. Areas in which we believe U.S. tax laws hinder the competitiveness of the U.S.-flag fleet include: (1) extending the depreciable life of U.S.-flag vessels; (2) repealing the Investment Credit; (3) repealing (Subpart F) deferrals; (4) reducing the limit on foreign income taxes creditable against U.S. income tax; (5) enacting the Alternative Minimum Tax; (6) reducing the deduction for meals to 80 percent; and (7) reducing the longstanding 50 percent ad valorem duty on foreign repairs. Each of these tax burdens are set forth more fully below.

1. General Tax Provisions of the 1986 Tax Reform Act

The Tax Reform Act of 1986 extended the depreciable life of U.S.-flag vessels from five to ten years and repealed the 10 percent Investment Credit. This was done through a revision to the Accelerated Cost Recovery System (ACRS). Under pre-1986 law, vessels documented under the laws of the United States and operated in the foreign or domestic commerce of the United States, as well as containers and other water transportation equipment, qualified as 5-year ACRS property. In addition, vessels and equipment qualified for the investment credit at the full 10 percent rate. Under the 1986 Act, vessel containers are generally 5-year property and vessels 10-year property, and are to be depreciated using a 200 percent straight-line method. Other water transportation equipment is generally 15-year property, and is to be depreciated using a 150 percent straight-line method. Furthermore, the investment credit was repealed for all types of property by the 1986 Act.

The Alternative Minimum Tax (AMT) provision of the 1986 Act will also have a substantial impact on the maritime industry. The effect of this provision is significant since AMT income includes amounts contributed to, and earning on, the Maritime Capital Construction Fund (CCF) that are deductible in calculating regular taxable income. Even more significant, the amount of net operating losses, which have been incurred in recent years due to the depressed state of the maritime industry, cannot reduce the

AMT by more than 90 percent, which greatly dilutes the economic value of the operating loss carryover.

The overall effect of these provisions in the 1986 Act must be weighed against the reduction in the maximum rate of the regular corporate income tax from 46 percent to 34 percent. The Coalition of Service Industries (CSI), using detailed cost models, has studied the impact of the deceleration of ACRS depreciation, repeal of the investment credit, and the implementation of the AMT. They estimated that for a shipowner to be able to fully utilize pre-1986 law deduction and credits, the cost of U.S.-flag ocean shipping could be increased by as much as 12 percent.

2. Repeal of Subpart F Deferrals

Many U.S. shipping companies have traditionally operated foreign-flag shipping through foreign subsidiaries. Under pre-1986 law, shipping income derived from these sources could be deferred under Subpart F by reinvesting profits in shipping assets, which was easily done in this highly capital intensive industry. The 1986 Act made four major changes to the Subpart F provisions. First, U.S. tax on shipping income earned through controlled foreign corporations can no longer be deferred by reinvesting those earnings in qualified shipping assets. Second, the rule for determining whether income is foreign or domestic source was changed from one based on the number of days a ship spent within U.S. territorial waters, to one under which 50 percent of income from transportation to or from the United States is U.S. source, which effectively increased the portion of total income which is domestic source and reduced that which is foreign source. Third, the foreign tax credit limitation will be applied separately to ocean shipping and other transportation income, thereby eliminating U.S. corporations' ability to apply excess foreign taxes from other foreign activities against the U.S. tax on transportation income. Fourth, the amount of interest expense which must be apportioned against various categories of foreign-source income was increased by the expense allocation rules.

The ability to operate foreign flag vessels through foreign subsidiaries is essential in today's shipping markets. Often, the success of a foreign subsidiary contributes to the strength of the U.S. based operations. The repeal of the Subpart F exclusions for reinvested shipping profits has been estimated to require a 4 percent increase in shipping rates.

3. Meal Deductibility

The Tax Reform Act of 1986 reduces the deduction available to employers for the cost of meals provided to employees, as well as other meals considered ordinary and necessary business expenses from 100 to 80 percent. Unfortunately, as interpreted by the Internal Revenue Service, this provision reduces the deduction available to owners and operators of vessels for the cost of meals provided to merchant seamen from 100 to 80 percent. Meals provided to merchant seamen were fully deductible prior to the Tax Reform Act. Limiting this deduction fails to take into account the unique circumstances under which meals are provided to merchant seamen, which are totally unlike those of the typical "business meal," or the common type of meal provided by an employer to an employee. In particular, such a limitation fails to take into account, that as a practical and legal matter, meals must be provided to merchant seamen by owners and operators of U.S.-flag vessels. Meals for merchant seamen are just as necessary an expense as are lifejackets for those same seamen, and fuel for the vessel, all of which are required before any vessel can go to sea. We estimate that the effect of reducing the deductibility for meals to vessel crews will cost the U.S.-flag maritime industry $15 million per year.

4. Ad Valorem Tariff on Foreign Repairs

Pursuant to the Tariff Act of 1930, a 50 percent tariff is currently levied in the cost of non-emergency foreign repairs that have been made in U.S.-flag vessels. This ad valorem duty adversely affects the ability of U.S.-flag vessels to compete with foreign flag carriers. By requiring U.S. flag vessels to return to the United States for such repairs, this ad valorem duty limits the flexibility of our liner operators, places undue hardship on our bulk carrier operation in foreign-to-foreign trades, and results in the interruption of service with a loss of operating revenues. Furthermore, since some foreign repairs are necessary, this duty costs the U.S. maritime industry approximately $10 million per year. This ad valorem duty was enacted primarily to protect U.S. shipyards. However, a proposal, which was developed jointly by the American Institute of Merchant Shipping and the Shipbuilders Council of America, would provide U.S.-flag operators a measure of flexibility and assist domestic repair yards. Our proposal would make the duty inapplicable if the owner or operator of the vessel elects to spend for equipment, or parts thereof, or repair parts or materials, or repairs in a domestic shipyard a cumulative amount at least equal to the duty he would otherwise have been liable for within five years of the first arrival of the vessel in a U.S. port. If the owner or operator fails to make the expenditure during the five year period, he is liable for the duty plus accrued interest computed at a rate to be determined by the Secretary of the Treasury from the date the duty would otherwise have been paid. A copy of our draft bill (and an explanatory statement) to implement our proposal is attached to this statement. It would be most helpful if the Chairman or any member of the Committee could introduce this bill for us. This is very important to both the shipyards and the operators, and is a reasonable and sensible way to deal with this "ad valorem on repairs" problem.

5. Conclusion

As we previously noted, other nations generally provide tax incentives and beneficial tax programs to enhance the competitiveness of their merchant fleets. Examples include lower tax rates, investment credits, and accelerated depreciation. In addition, virtually no foreign shipping companies are subject to comparable Subpart F taxation. Furthermore, crew meals are not taxed on foreign flag ships, nor do foreign shipping companies have restrictions on vessel repairs. Since the overall effect of the U.S. tax policy increases the cost of U.S.-flag shipping, the ability of our vessels to compete is severely limited.

We feel that this statement is very responsive to the Subcommittee on Taxation and Debt Management's consideration of the question of the effect of our tax laws on American competitiveness. If the Subcommittee is willing, it can greatly help the U.S.-flag maritime industry in the areas mentioned above.

STATEMENT OF
THE ASSOCIATION OF AMERICAN UNIVERSITIES

The Association of American Universities (AAU), which represents 54 of our nation's major research universities, and the organizations listed below are pleased to submit for the record this testimony on the impact of the U.S. tax code (particularly those sections that deal with graduate education and research) on America's international competitiveness.

The link between the U.S. tax code and America's international competitiveness is perhaps nowhere as evident as in the activities of research universities. The tax code affects many aspects of America's universities: gifts of appreciated property and other charitable contributions support them; the issuance of tax-exempt bonds helps maintain them; tax-free tuition remission attracts talented students; and research tax credits and exemptions from the unrelated business income tax determine how much and what kinds of research colleges and universities perform. A competitive economy is dependent upon those resources that our nation's universities are uniquely situated to provide, that is, an educational environment and research infrastructure designed to encourage new knowledge and highly trained individuals.

Of the myriad of tax issues affecting our nation's institutions of higher education, three areas of the tax code are discussed here because they are particularly relevant to the ability of research universities to carry out their missions in areas of interest to this Committee:

1) the tax treatment of tuition remission granted to graduate students engaged in part-time teaching or research;

2) the treatment of research under the unrelated business income tax;

3) research and development tax credits.

Since World War II, the federal government has looked to universities as a primary source of new scientific knowledge and innovation. In "Science, the Endless Frontier," prepared in 1945 at the request of President Truman by Vannevar Bush, a policy accepting federal responsibility for the support of research was first articulated. The establishment of the National Science Foundation in 1950 was one of the first manifestations of this policy. Since the publication of Bush's seminal report, our colleges and universities have developed a unique national system for the conduct of basic research which has evolved into a complex and overlapping set of connections between the federal government and universities. According to the 1986 report of the White House Science Council on the Health of U.S. Colleges and Universities, America's universities now perform more than 60 percent of the nation's fundamental research.

This expansion of university research complemented higher education's traditional goals of teaching and preservation of knowledge. Research and advanced training go together, and the university provides for them an appropriate institutional setting. As a result, the system has grown and developed because it has proven to be productive, efficient, and a powerful tool for the creation and dissemination of high-level knowledge.

TAX TREATMENT OF SCHOLARSHIPS AND FELLOWSHIPS

The training of graduate students and postdoctoral fellows is an integral part of college and university research programs. The vitality of the sciences and engineering disciplines depends on the infusion of new talent, ideas, and innovation through the training of young people and the maintenance of the scientific manpower "pipeline." Equally important is the transfer of knowledge and technology that occurs when students trained at universities take their degrees and find employment in industry and the national laboratories, bringing to their work their skills and familiarity with new ideas, techniques and technology.

In this time of concern for America's international competitiveness, the provision of continued unambiguous exclusion from taxation of tuition reduction grants provided in conjunction with part-time services required to fulfill degree requirements is extremely important, to ensure that talented graduates are not discouraged from pursuing careers in scholarship and research. In addition, such a result would do no damage to the principle established in the Tax Reform Act of 1986, which provides that nontuition portions of scholarships should be subject to tax. A technical correction which clarifies the continued exclusion of tuition remission from the taxable income of graduate students engaged in part-time teaching or research should be enacted at the earliest opportunity.

UNRELATED BUSINESS INCOME TAX

Research universities maintain a diverse base of functions, of which the education and training of graduate students is but one component. In the public eye, the primary mission of postsecondary institutions is as general teaching institutions, and, indeed, according to the Office of Educational Research of the U.S. Department of Education, American colleges and universities now confer almost one and a half million degrees a year (bachelors', masters', first professional, and doctors' degrees combined). Universities also provide a broad range of public services from the maintenance of agricultural extension stations to the generation of cultural performances and exhibitions. Of perhaps greatest relevance to the issue of international competitiveness, though, universities perform the research and training that has set a world standard, and on which the nation depends to maintain our scientific and technological preeminence in the competitive global environment. The percentage of foreign students pursuing doctorates at American universities is "a very persuasive endorsement of the quality of U.S. graduate education in engineering, mathematics, and the natural sciences..." (The Report of the White House Science Council on the Health of U.S. Colleges and Universities, February 1986). America looks to its research universities to remain competitive in the global marketplace, particularly at this time.

Since World War II, the United States has been a leader in fundamental research; however, in recent years we have failed to match the economic performance of Japan, a country with a far more limited foundation in basic science. The developing gap between our scientific success and our ability to transfer those achievements into productivity gains demonstrates that private industry cannot be relied upon as the sole bridge. Economic studies prove that the return to a private sponsor of applied research which is not directly linked to product development or industrial operations is less than one-half the return to society as a whole (Bailey and Lawrence, "Tax Policies for Innovation and Competitiveness", April 3, 1987, at pp.26-28). Moreover, the distinction between basic and applied research is increasingly blurred. Those technologies which enable us to utilize basic scientific principles have become fundamental in fields such as electronics, optics, metallurgy, and genetics.

The Internal Revenue Code excludes from the term "unrelated business taxable income" (UBTI) all income derived from research performed for any person by a college, university or hospital. For purposes of this exclusion, no distinction is made in the Code or Regulations among various types of research such as "fundamental", "basic", or "applied". Accordingly, the exclusion from UBIT for college and university research encompasses both fundamental and applied research up to the point of ordinary commercial or industrial operations.

Universities now play a significant role in bridging the gap between basic research and commercial exploitation. The conduct of applied research facilitates technological procedures which will make them more valuable to private industry. In addition, the performance of basic and applied research contributes importantly to the progress of knowledge and educational opportunities for a university's students and faculty. Nevertheless, the specific research exclusion is necessary to ensure that university applied research is not imprudently restricted.

The specific current law exclusion of university research from UBIT ensures that a university, which pursues a research project up to but no further than that point at which there is commercial application, will not be penalized with a federal income tax burden. Thus, the existing research exemption and the exclusion for royalty income are the basic tax incentives for universities to undertake public/private partnerships in the development of new technologies. Universities that develop projects with commercial potential must then transfer or license the results of this technology to private industry or be subject to tax. Thus, the current tax code appropriately provides incentives for investment in vital university research which cease--and even become disincentives--at the point where the technology becomes commercially viable and private industry can be expected to take over.

RESEARCH TAX CREDITS

The research and development (R&D) and basic research tax credits also have a significant impact on the types and amounts of research--recognized as crucial to our international competitiveness--performed at American universities. The R&D Tax Credit was first adopted in 1981 as part of the Economic Recovery Tax Act. It provided a 25 percent credit for increases in company R&D spending above that company's average R&D spending for the prior three-year period. Although the original credit expired on December 31, 1985, it was extended (retroactive to the original expiration date) as part of the Tax Reform Act of 1986. The credit's incremental rate was reduced from 25 percent to 20 percent.

According to the Council on Research and Technology (CORETECH), an organization of over 70 universities, 40 companies, and 15 national industrial and higher education associations, the R&D tax credit has been in effect during a period of dramatic increases in private R&D spending which rose from $30.9 billion in 1980 to $60 billion in 1986. Drs. Martin Bailey and Robert Lawrence, Senior Fellows at the Brookings Institution, estimate that the R&D tax credit increased private R&D spending by 7 percent over and above what it would have been had the credit not been in effect. Thus, the true value of the credit, because it is incremental (i.e., applies only to increases in R&D spending) against a rolling base (the average R&D spending of the prior three-year period), was on the order of 7 percent.

According to CORETECH, the legislative history of the credit indicates that the R&D tax credit was designed to offset what almost all economists believe is a structural underinvestment in research and development. Although the rewards to society of innovation are great, the market rewards to those who undertake the risks of R&D are insufficient to support an optimal level of research and development. Viewed in the context that industrial innovation yields a return to society as a whole that is 50 percent over and above a company's own return, the tax credit has been a first rate investment.

Continued high levels of investment in R&D are fundamental to economic and productivity growth and, almost by definition, international competitiveness. According to Drs. Bailey and Lawrence, using standard economic assumptions (and a 25 percent rate for the credit), a permanent R&D tax credit could add more than $17 billion annually to the GNP beginning in 1991.

Congress adopted a new tax credit for company support of basic research in the Tax Reform Act of 1986. The new Basic Research Credit can be claimed at a fixed rate of 20 percent of total contract research payments that are over a company's average spending for basic research during the fixed base period of 1981-83. Contract payments and grants to universities and other nonprofit research institutions for basic research qualify for the new credit. The advent of a tax credit in support of basic research has enormous potential, since, as the White House

Science Council observed in its 1986 report, "most basic research can rarely be perceived in terms of specific products and services, and given the long-range nature of such research, private industry does not often support a high level of basic research. If one thing has become clear in recent decades, it is that the fruits of basic research provide benefits for all of society, frequently in ways not visible initially to any of the participants." The new Basic Research Credit is in effect from January 1, 1987 to December 31, 1988. The AAU strongly supports H.R. 1957, introduced by Rep. Pickle (D-TX), which would make both the R&D Tax Credit and Basic Research Credit permanent sections of the U.S. tax code.

CONCLUSION

Colleges and universities have played and will continue to play an essential role in this nation's research and development effort. That effort is inextricable from our nation's ultimate success as an international competitor. In our view, federal tax policy designed to foster international competitiveness must continue to recognize and encourage the appropriate role of the American university as an indispensable partner in any effort by the United States to excel in the international marketplace. Congress' recognition of these issues as important to both universities and society as a whole is gratifying.

The following associations join us in our statement:

American Council on Education
National Association of Independent Colleges and Universities
National Association of State Universities and Land-Grant Colleges

MICKY ARISON, PRESIDENT

CARNIVAL CRUISE LINES

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

Your hearings on the impact of the U.S. tax code on America's international competitiveness are very timely. I welcome this opportunity to present to you information regarding one change in the tax code which has made an imbalance in the competitive nature of the cruise industry in the Caribbean, giving a distinct advantage to our foreign-owned competitors

Before addressing the tax provision concerned, let me outline briefly the operations of Carnival Cruise Lines, a U.S.-owned company, based in Miami.

Carnival carries 10,000 passengers every week to Caribbean destinations on a fleet of six ships serving the southern and eastern Caribbean. While our major emphasis is in the Caribbean, we have one ship sailing from Los Angeles serving the Mexican coast. All of our ships operate on a year round basis and in 1986 carried 443,132 passengers. We project a total in 1987 of approximately 550,000 passengers.

As good citizens of the Miami area where Carnival is based and as an American-owned business citizen of our nation, our company maintains a strong U.S. identification, although our operations are serving the Caribbean nations. Carnival is a strong supporter of the Caribbean Basin Initiative (CBI) which is an important part of the U.S. trade policy.

Carnival Cruise Lines is a totally U.S.-controlled company with all of the ownership in legal title of U.S. citizens. As is the case with all passenger vessels operating in the Caribbean area and with nearly all other passenger vessels operating out of U.S. ports, our vessels are foreign built which effectively makes U.S. registry impractical. Our vessels are registered in Panama and fly that flag. However, our major competitors are foreign corporations, and are all foreign registered and foreign flagged.

Since Carnival is one of the only operators of U.S.-controlled passenger vessel in the United States, we are in an unique position to offer our ships to this country in cases of national emergency. Our vessels are included within the definition of the Effective U.S. Control (EUSC) Fleet.

As you know, the EUSC is comprised of merchant and passenger vessels, controlled by U.S. companies, but registered in foreign countries, such as, Liberia, Panama, Honduras or the Bahamas, and by reason of the provisions of Section 902 (a) of the Merchant Marine Act of 1936 are subject to requisition in time of war or national emergency, regardless of registry.

The history of EUSC policy dates back to the early days of World War II when American companies, acting at the request of the U.S. government, made available their Panamanian, Honduran and Venezuelan flag ships as part of the effort to supply Great Britain and France with essential supplies, a trade barred to American flag ships by the Neutrality Act of 1939. The policy of the EUSC fleet has developed from that time through the Joint Chiefs of Staff with the use of these vessels continuing in Korea and Vietnam.

Under hypothetically optimum conditions U.S. emergency sealift needs would be covered by a sufficient number of modern U.S. flag passenger and merchant vessels of the desired types and sizes which are in active service, are owned, operated and manned by Americans, and are able to compete in commercial markets without government supports during peacetime. However, optimum conditions have not existed for many decades. With minor exceptions, U.S.-flag vessels have not been able to compete in international shipping without direct or indirect subsidies and such supports have usually been limited by budgetary and other constraints. This reality has compelled defense planners to look beyond the hypothetical and rely on additional coverage from government owned vessels in the reserve fleets, vessels owned and operated by American companies in the EUSC fleet and vessels flying flags of its NATO partners.

EUSC vessels offer some unique advantages as a supplement to available U.S. flag tonnage. Unlike vessels in the reserve fleets, they are, for the most part, in active service and at any given time are dispersed in various places. The EUSC fleet and especially the passenger vessels are much younger in age and productivity. Unlike NATO vessels, they are operated by American companies based in the U.S. and can be brought under direct control of U.S. defense officials under the law.

If it is feared that the friendly flag nations may change their laws or policies and thus interfere with the free exercise of U.S. law to requisition, use or charter the EUSC vessels, this subcommittee could recommend reasonable provisions to strengthen U.S. control.

Carnival's passenger vessels, all seaworthy and meeting all safety standards, are ready today as part of the EUSC fleet. Should national emergencies require their use, such as the government of Great Britain suddenly found in its conflict in the Falkland Islands, when it requisitioned the use of the Queen Elizabeth II to transport its troops on very short notice, Carnival's ships would be ready and available for similar service.

The reliance on the Effective U.S. Control Fleet has been repeatedly acknowledged by U.S. military and Department of Defense officials. In 1962, Congress adopted a provision which allowed U.S.-controlled corporations an exemption from taxation on shipping assets.

This provision, known as Subpart F, was enacted "primarily in the interests of national defense." Then in 1974, a more limited deferral, conditioned on re-investment of shipping assets in new shipping ventures, was adopted. At that time, the House Ways and Means Committee elaborated on the congressional intent for this tax deferral. The committee report said:

> "This committee recognizes that the competitive nature of shipping operations makes it difficult to impose taxes on the profits of the foreign flag fleets of U.S. persons so long as the foreign flag fleets of other nations are not subject to any significant income taxes. The interests of the United States are best served if we have a significant U.S.-owned maritime fleet."

Competition within the cruise industry is very intense and will become increasingly so. If the shipping income of a foreign-owned competitor is either untaxed or tax-deferred, while a U.S.-owned company, such as Carnival is taxed, the inevitable result is to place U.S. companies at a severe competitive disadvantage with respect to capital formation.

This, in turn, will cause an even more sharp decline in the size of the U.S.-controlled fleet, with attendant detrimental national security implications.

Last year in the 1986 tax legislation, the Congress, probably unknowingly, dealt a severe blow to national security and the continuation of the Effective U.S. Control Fleet. The tax deferral under Subpart F was repealed but the real intentions of the Congress are not clear. Even though no testimony was heard on the issue in the House Ways and Means Committee, the House bill carried the repeal of the tax deferral on reinvested income. Later, the Senate

Finance Committee, after hearing arguments against repeal, reached the opposite conclusion and the Senate bill passed supporting the continuation of the tax deferral on reinvested income. It is not clear what happened in the conference because the issue was never directly debated, but Subpart F was presumably traded off for other issues having nothing to do with shipping. While the U.S.-owned companies and the national security interests of the U.S. are clearly the losers of this decision, the real tragedy is that there are conversely no winners in this decision.

To illustrate the dilemma facing U.S.-owned companies, let me tell you what our company must decide. First, we can try to continue to compete in the highly competitive market with our foreign-owned competition, but realizing that they do so with no tax responsibilities to the United States and probably little or none to the nations of their ownership and registry.

While Carnival, as a U.S. company, would be struggling to maintain its ships out of after-tax dollars, our foreign competitiors would be free to maintain their ships with revenue which is tax-free in the U.S. and possibly worldwide. The other alternative is no more inviting, although it solves the tax problem. That is the choice to transfer majority ownership in Carnival to foreign interests. It obviously removes these vessels from the shrinking number of ships in the EUSC and would remove tax revenues arising from U.S. ownership and employment. Neither result is good for our national interests.

The grave implications of the tax deferral repeal for national security is more clearly understood when you consider that approximately 300 vessels are presently under U.S.-control which could be requisitioned, used or chartered in a national emergency, but of those only 10 are passenger vessels. If this small cadre of passenger vessels are removed from the dwindling numbers of the EUSC fleet through foreign competition, aided and enhanced by U.S. tax policy, then the nation has severely disabled a policy which has been important, strategic and very effective for many decades past.

I urge the subcommittee to carefully examine the repeal of Subpart F as it relates to tax deferral of reinvested shipping income.

With the imbalance in competitiveness between U.S.-owned and foreign-owned operators in the cruise industry, it is apparent that this advantage created by the repeal of the Subpart F provisions for reinvested shipping income is not fair and should not continue. The conference committee on the 1986 tax bill probably did not weigh the serious consequences of this action but this subcommittee now has the jurisdictional responsibility to rectify this error.

The purpose of this hearing is to focus attention on those sections of the U.S. Tax Code which have an adverse affect on America's international competitiveness. I applaud your diligence in examining these problems and express the sincere hope that it will lead to solid and forthright recommendations to the Senate Finance Committee to correct these erroneous policies. In the case of the repeal of the Subpart F deferral for reinvested shipping income, the continuation of this present policy will actually force the flight of U.S. ownership of vessels engaged in U.S. trade and commerce into the very control of foreign competition. Once lost, it will be virtually impossible to regain. This is done not only to the detriment of American business, but in the case of the EUSC fleet, also to the detriment of important and strategic national security interests.

The simplest remedy would be to reinstate the previous IRS code provision for reinvested shipping income, if not for all affected vessels, certainly then at least for the very small number of passenger vessels which are U.S.-owned and U.S.-controlled. If that is not deemed possible at this time, then Carnival requests that in fairness it should be entitled to an adequate transition rule covering vessels adversely affected at this time.

For the subcommittee to do nothing on this matter would be to abdicate its authority and jurisdiction in an area of vital importance - unfair foreign competition, brought about by the changes in the U.S. tax code. Without appropriate action then it is likely that one more segment of our economy would become an "unfair foreign competitor."

Thank you for your consideration of my testimony. I would be pleased to respond to any questions you may have.

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